

Hire Spouse to Work in a Family Business

Tax Issue

A sole proprietor can deduct health care costs that are paid for an employee as a business expense. By deducting the expenses directly on Schedule C (or Schedule F for a self-employed farmer), the deduction reduces both income tax and self-employment tax. It also reduces the FICA tax of an employee. Since the sole proprietor is not considered an employee of the business, his or her own health care expenses (and health care for members of his or her family) are not deductible on Schedule C or F. Rather, the self-employed individual can claim an above-the-line deduction on the front of Form 1040 for health insurance paid. The self-employed health insurance deduction reduces income tax, but not self-employment tax. The self-employed health insurance deduction also does not work under a medical reimbursement plan. Health care expenses not covered by insurance that are paid on behalf of the sole proprietor (and his or her family) are deductible on Schedule A, subject to the 7.5% AGI limitation.

For tax year 2010, the self-employed health insurance deduction was also allowed as a deduction against SE tax. This provision applied to tax year 2010 and has not yet been extended for any tax year after 2010.

Applicable Tax Law

- Medical expenses are generally deductible on Schedule A as an itemized deduction, subject to the 7.5% AGI limitation.
- The self-employed health insurance deduction allows a sole proprietor to deduct his or her health insurance premiums as an above-the-line deduction on the front of Form 1040, rather than as an itemized deduction on Schedule A. The deduction (other than for tax year 2010) does not reduce the sole proprietor's self-employment tax. The deduction is limited to health insurance and does not include out-of-pocket medical expenses that are not covered by insurance.
- Employer-provided health insurance and health reimbursement arrangements offered to employees is excluded from employee wages and deductible by the employer. If a sole proprietor is an employer and hires his or her spouse as a bona fide employee, health benefits provided to the employee-spouse are excluded from the spouse's wages and deductible by the sole proprietor on Schedule C (or Schedule F). The deduction reduces both income and self-employment tax.
- An accident and health insurance policy must be purchased in the name of the employee-spouse to exclude the benefit from gross income. If the insurance is purchased in the name of the self-employed person, then the deduction for the cost of insurance cannot be claimed on Schedule C (or Schedule F).
- In order for a spouse of a sole proprietor to be treated as a bona fide employee, close scrutiny is required to determine whether a bona fide employer-employee relationship

exists and whether payments are made on account of the employer-employee relationship or on account of the family relationship. The employee-spouse must perform actual services for the business and be paid an actual wage as an employee.

- An employer-employee relationship cannot exist unless the employer has the right to control the activities of the employee.
- Other factors that support the employer-employee characterization include consistent work by the employee for the employer, the payment of employee benefits, services provided by the employee that are integral to the business operations, employee training provided by the employer, and the existence of an employment contract.
- If the employer establishes a medical reimbursement plan, the plan must be in writing [Reg. §1.105-11(b)(1)(i)], the employer must inform all employees of the plan, and the employees must meet the participation requirements of the plan.

Tax Planning Strategies

Deduct health insurance directly on Schedule C or F. A sole proprietor can deduct the cost of his or her health care directly on Schedule C or F by hiring his or her spouse to work in the family business. A deduction for 100% of the cost of providing health coverage for the sole proprietor (and his or her family) may be claimed by doing the following:

- The sole proprietor hires his or her spouse as a bona fide employee of the business.
- The employee-spouse performs services for the business as an employee.
- The sole proprietor provides family accident and health coverage for all employees of the business, including the employee-spouse.
- Accident and health coverage for employees (including the employee-spouse) may be provided either through a self-insured medical expense reimbursement plan under section 105(b) or by purchasing an accident and health insurance policy under section 106(a).
- The cost of health coverage and medical expense reimbursements are excluded from the employee-spouse's gross income and are deductible as a business expense by the sole proprietor. (Rev. Rul. 71-588)
- The sole proprietor is then covered by the plan as a member of the employee-spouse's family.
- If the sole proprietor offers accident and health coverage through a self-insured medical expense reimbursement plan, deductible expenses include reimbursed medical expenses for health insurance premiums and other costs not reimbursed by insurance. A medical reimbursement plan converts expenses that would otherwise be Schedule A itemized deductions subject to the 7.5% AGI limitation into deductible business expenses.

Other fringe benefits. If the spouse is hired as a bona fide employee of the sole proprietor, other fringe benefits deductible by the business and excluded from the employee-spouse's income could be provided, including group term life insurance, meals and lodging, and transportation benefits.

Not subject to FUTA. If the spouse is hired as a bona fide employee of the sole proprietor, taxable wages paid to the employee-spouse are not subject to federal unemployment taxes (FUTA).

Retain family income. If the spouse is hired as a bona fide employee of the sole proprietor, money used to pay the wages of the employee-spouse remain within the family of the sole proprietor, in contrast to wages paid to a non-family employee to perform the same job.

Examples

Example #1: Jeff is an independent insurance agent doing business as a sole proprietor. He has one employee named Jill who does bookkeeping and general office work. Jeff pays Jill \$30,000 per year. After deducting her wages, payroll taxes, and other business expenses, Jeff's net self-employment income equals \$75,000. Jeff has a wife named Shawn. She earns \$30,000 per year as an employee doing office work for another company. Shawn's employer does not offer any health care benefits. Jeff purchases health insurance for his family, but does not offer any benefits to his employee. The cost of his family health insurance is \$8,400 per year. Assume Jeff and Shawn have no children and have \$20,000 in itemized deductions. They also pay \$2,000 per year out-of-pocket in medical expenses not reimbursed by insurance, such as co-pays, dental, and vision care. Since these expenses do not exceed the 7.5% AGI limitation for medical expenses on Schedule A, they are not deductible. For 2011, their tax return is calculated as follows:

Jeff's Schedule C net profit.....	\$75,000
Shawn's W-2 wages.....	30,000
Minus one-half SE tax deduction.....	(5,299)
Minus self-employed health insurance deduction.....	(8,400)
AGI.....	\$91,301
Minus itemized deductions.....	(20,000)
Minus personal exemptions.....	(7,400)
Taxable income.....	\$63,901
Federal income tax.....	8,739
SE tax (13.3% rate for 2011 only).....	9,212
Shawn's share of FICA (5.65% rate for 2011 only).....	1,695
Total 2011 federal tax liability.....	\$19,646

After taxes and the cost of health care, funds available equal \$74,954 (\$75,000 + \$30,000 – \$19,646 – \$8,400 – \$2,000).

Example #2: Assume same facts as Example #1, except that instead of hiring a non-relative (Jill) to work as an employee, Jeff hires his wife Shawn to work as his only employee (Shawn works for Jeff instead of the other company). Assume Jeff saves \$500 in FUTA taxes, state unemployment taxes, and workers compensation insurance for hiring his spouse to work for him rather than a non-relative. Jeff offers an employer-provided health reimbursement plan for his employees and their spouses, which reimburses the cost of health insurance and up to \$2,000 of other medical expenses not covered by insurance. As the spouse of his employee, the \$10,400 (\$8,400 + \$2,000) cost of health care for Shawn and her husband (Jeff) is deductible by Jeff on Schedule C and excluded from Shawn's W-2 wages. For 2011, their tax return is calculated as follows:

Jeff's Schedule C net profit (\$75,000 + \$500 – \$10,400)	\$ 65,100
Shawn's W-2 wages.....	30,000
Minus one-half SE tax deduction.....	(4,599)
AGI.....	\$ 90,501
Minus itemized deductions.....	(20,000)
Minus personal exemptions	(7,400)
Taxable income.....	\$ 63,101
Federal income tax	8,619
SE Tax (13.3% rate for 2011 only).....	7,996
Shawn's share of FICA (5.65% rate for 2011 only).....	1,695
Total 2011 federal tax liability.....	\$ 18,310

After taxes and the cost of health care, funds available equal \$76,790 (\$65,100 + \$30,000 – \$18,310). Thus, Jeff saves \$1,836 (\$76,790 – \$74,954) by hiring his wife to work for him rather than a non-relative.

Possible Risks

- The IRS is very aggressive in trying to claim the employee-spouse is not a bona fide employee of the business. The payments made under the accident and health plan must be on account of the employer-employee relationship and not on account of the family relationship. There are many facts and circumstances that could go against the taxpayer if the employer-employee relationship is not firmly established.
- The accident and health policy generally must be purchased in the name of the employee-spouse to exclude the benefit from gross income. Make sure the insurance policy is not in the name of the sole proprietor.
- Medical reimbursement plans that discriminate in favor of highly-compensated employees are taxable to those employees. If the business employs individuals other than the employee-spouse, and those other employees need to be covered by the medical reimbursement plan due to the nondiscrimination rule, the cost to the employer can be prohibitive.
- The compensation paid to the employee-spouse needs to be reasonable for the services performed. Compensation includes wages paid and the medical reimbursement plan. There is no fixed standard for determining reasonable compensation. It is determined on the facts and circumstances of each case.
- The temporary law that allowed the self-employed health insurance deduction against SE income of the sole proprietor could be reinstated under new tax legislation. If it is reinstated, all of the extra planning involved with hiring a spouse as an employee could be made meaningless if the sole purpose of the plan is to reduce SE tax.
- If the spouse is actually an independent contractor of the business rather than a bona fide employee, the cost of accident and health insurance benefits that are provided to the spouse are not excluded from the spouse's gross income.
- The IRS could claim the spouse is actually a co-owner of the business rather than an employee. Factors that indicate co-ownership include joint ownership of business assets, joint sharing of profits, and joint control over business operations.

- Non-tax issues could be a problem. Spouses don't always get along working together in a business relationship, particularly if one spouse is the boss of the other.

Court Cases

Court Case: The IRS contended a husband was not a bona fide employee of his wife's day care business. The court ruled in favor of the taxpayer. He had a contract to work for the day care, his wife had the right to control his activities, she set the amount of compensation he received, and she had a right to terminate his employment. The taxpayer also submitted written records of his work schedule, and that the work performed was integral to the day care's operation. Payments were made on account of the employer-employee relationship, not on account of the family relationship. (*Speltz*, T.C. Summary Opinion, 2006-25)

Court Case: Although the taxpayer and his spouse had a bona fide employment agreement, a deduction on Schedule F for health insurance premiums and medical expenses were not allowed under the provision for employee-spouse health insurance. The taxpayer failed to prove that the expenses for health coverage were incurred and paid by his spouse. The employer-spouse was the primary insured under the policy, and it was established that he incurred and paid the expenses in question, not his employee-spouse. The Court determined that the amounts were not paid under an employee benefit program. (*Albers*, T.C. Memo 2007-144)

Court Case: The Court ruled a farming taxpayer, whose wife was a bona fide employee, could reimburse her for medical expenses through a medical reimbursement plan set up for his employees, even though one of the reimbursements made was for a joint health insurance plan in the taxpayer's name. The IRS contended the wife could only be reimbursed for medical costs and insurance in her name. The Tax Court concluded that since the employee-wife had paid nearly all the premiums from an account in her name, the deductions were allowable. (*Frahm*, T.C. Memo 2007-351)

Court Case: The taxpayer hired his wife as an employee of his farm business. He paid her fringe benefits which included \$15,000 to \$20,000 of medical reimbursements that included medical expenses for his employee-spouse, their two children, and the taxpayer himself. This allowed the taxpayer to deduct his entire family's medical expenses on Schedule F. The IRS disqualified the entire amount received by the wife because the actual money originated from her and the taxpayer's joint checking account. The IRS claimed the amount paid to the wife wasn't compensation, it was just money going from one pocket into another pocket.

The Tax Court agreed with the IRS. If the wife didn't receive any compensation, that means there was no bona fide employment relationship between the taxpayer and his wife because the relationship lacked economic substance. In essence, the Tax Court found that the purported employment agreement was a mere formality.

The Court of Appeals rejected the Tax Court's argument that the taxpayer must look where the money comes from when determining if a bona fide employee arrangement exists. The Court of Appeals also dismissed the Tax Court's argument that funds for

medical reimbursement must be paid from a separate account. The Court said: "A separate account requirement would simply invite another structural layer: here, a separate account for the business of the farm, from which funds would simply be transferred to the general joint account and/or to [the employee-spouse's] separate account (plus, the business account would probably be in joint tenancy anyway because the business relied on (her) to do the bookkeeping)."

"The argument that [the employee-spouse] received no economic benefit because her financial position with a separate account was the same as without it ignores the reality of spousal employment. Combined gross income would obviously not change. Employment of a spouse in a small business is done to avoid decreasing the couple's income, which would result from paying an unrelated hired hand. And, to narrow these kinds of cases to situations where the employed spouse is setting up a completely separate asset portfolio with her separate account does not find a supporting requirement in the reported cases." (*Shellito*, T.C. Memo 2010-41, March 3, 2010, and *Shellito*, 10th Cir., August 24, 2011)