Hiring Your Spouse as an Employee

This letter is intended to respond to your questions about some of the federal income tax pros and cons of hiring a spouse as an employee in a family business. The advantages generally flow from the ability of the spouse to receive tax favored fringe benefits in his or her capacity as an employee. The disadvantages principally flow from the added employment tax and other liabilities that are generated, especially when a related person is an employee.

One word of caution up front: most closely-held S corporations are foreclosed from realizing any benefits from hiring the spouse as an employee. The spouse of a more than 2-percent S corporation stockholder is automatically treated as a more than 2-percent owner, which forecloses most employee fringe benefit deductions.

Health insurance: A spouse who is hired as a bona fide employee generally can be given health insurance coverage that includes coverage for all family members, including the principal owner spouse, thereby effectively converting all family health insurance premiums into business expenses.

Self-employment tax: At 15.3% of earnings, the self-employment tax should play a role in deciding whether to have medical premiums and other fringe benefits written off as a trade or business deduction through a spouse-employee. Even starting in 2003, when health insurance costs will be 100% deductible for the self-employed, there will still be benefits to setting up a medical plan which is deductible as a business expense since the deduction will continue to reduce, dollar for dollar, the profits on which self-employment tax is computed.

Running the numbers usually reveals the continuing benefit of having a spouse as an employee covered under a health plan in which the rest of the family, including the owner-spouse, are covered as dependents. And although the wages of the spouse are subject to FICA, the spouse is able to build up Social Security and Medicare credits.

Section 105 reimbursement plan: Setting up a "section 105" medical reimbursement plan under which the spouse-as-employee is covered creates benefits in addition to a business expense deduction for health insurance premiums. The spouse can also use the plan to deduct insurance co-pays, noncovered prescriptions, eye glasses, dental care, orthodontics, and other medical expenses that would otherwise be confined to an itemized "Schedule A" deduction subject to the difficult-to-reach 7.5% floor. In addition, an employee spouse would be entitled to $50,000 of group-term life insurance premiums and disability premiums as nontaxable fringe benefits.

Retirement plan impact: Having a spouse count as an employee is a double-edged sword in several respects. For example, ownership attribution for tax purposes is a problem. The basic definition of a highly compensated employee is one either earning above the threshold level (generally $85,000) or a 5 percent owner. As a result, a spouse who is deemed to be a highly compensated employee or even a key employee will limit a small business owner's ability to use an age-related or cross-testing of the retirement plan.

Nevertheless, in certain instances having a spouse as an employee can help direct more retirement benefits to the owner. This apparent paradox works because of the testing rules for "highly compensated." For example, when a spouse is on the payroll as a lower paid employee such as an office manager, choosing to exclude the spouse from participation in a retirement plan can have a positive effect on cross testing, since the percentage of highly compensated employees covered under the plan is reduced dramatically. Because of the attribution rules, there would then be two highly compensated employees. By excluding the spouse from participation in the plan, only 50% of highly compensated employees are covered, thereby reducing the percentage of non-highly compensated employees that need to participate in the plan to avoid top heavy rules, or creating a favorable computation for the average benefits test.

Other employee perks: Often small business owners will want to hire their spouses to get them onto the travel and entertainment budget more easily. Unfortunately, even if one of the spouses uses a maiden name, the similar address of the taxpayers, as well as disclosures if a retirement plan is in operation, will guarantee closer IRS scrutiny during any travel and entertainment audit. These expenses may be recharacterized as gifts or disguised dividends. In addition, certain provisions of the Internal Revenue Code specifically address the expenses of a spouse, whether as a spouse or an employee. Under Treasury Department regulations, a taxpayer may not deduct travel expenses paid or incurred for a spouse (or dependent) unless the spouse or other individual is a bona-fide employee of the employer, the travel is for a bona-fide business purpose, and the expenses of the spouse or other person are otherwise deductible.

If you need a more detailed explanation of how any of the above-mentioned items would apply to your business situation, please do not hesitate to call.