MICHAEL F. GIUFFRE,
AN ACCOUNTANCY CORPORATION
Tax-Saving Tips

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Strategic Insights for Employing Your Spouse

If you own your own business and operate as a proprietorship or partnership (wherein your spouse is not a partner), one of the smartest tax moves you can make is hiring your spouse to work as your employee.

But the tax savings may be a mirage if you don't pay your spouse the right way. And the arrangement is subject to attack by the IRS if your spouse is not a bona fide employee.

Here are four things you should know before you hire your spouse that will maximize your savings and minimize the audit risk.

1. Pay benefits, not wages. The way to save on taxes is to pay your spouse using tax-free employee benefits, not taxable wages. Benefits such as health insurance are fully deductible by you as a business expense, but not taxable income for your spouse.

Also, if you pay your spouse only with tax-free fringe benefits, you need not pay payroll taxes, file employment tax returns, or file a W-2 for your spouse.

2. Establish a medical reimbursement arrangement. The most valuable fringe benefit you can provide your spouse-employee is reimbursement for health insurance and uninsured medical expenses. You can accomplish this through a 105-HRA plan if your spouse is your sole employee, or an Individual Coverage Health Reimbursement Arrangement (ICHRA) if you have multiple employees.

3. Provide benefits in addition to health coverage. There are many other tax-free fringe benefits you can provide your spouse in addition to health insurance, including education related to your business, up to $50,000 of term life insurance, and de minimis fringes such as gifts.

4. Treat your spouse as a bona fide employee. For your arrangement to withstand IRS scrutiny, you must be able to prove that your spouse is your bona fide employee. You'll have no problem if

- you are the sole owner of your business,
- your spouse does real work under your direction and control and keeps a timesheet,

- you regularly pay your spouse's medical and other reimbursable expenses from your separate business checking account, and
- your spouse's compensation is reasonable for the work performed.

The Kiddie Tax and How to Avoid It

The kiddie tax was enacted by Congress to prevent parents from passing investment income to their children, who typically have a lower tax rate. Under the kiddie tax rules, a portion of a child's net unearned income may be taxed at the parent's marginal federal income tax rate. The kiddie tax applies to children up to age 24, assuming they meet certain criteria.

The kiddie tax can result in higher taxes on an affected child's net unearned income than otherwise would apply. For example, if a child's net unearned income exceeds the annual threshold of $2,500 for 2023, the portion of the income exceeding the threshold is subject to the kiddie tax.

The kiddie tax does not apply if the child's net unearned income for the year remains below the threshold for that year.

There are four primary criteria for the application of the kiddie tax, including the child not filing a joint return for the year, at least one parent being alive at year's end, the child's net unearned income for the year exceeding the threshold for that year, and the child not meeting the specific age rules.

With these rules in mind, there are several strategies to limit the kiddie tax's impact on your child's unearned income:

Exploit the unearned income threshold. Manage your child's unearned income to ensure it remains below the annual threshold.

Pick the right investments. You can reduce unearned income by selecting investments with minimal or no dividends, such as growth stocks or tax-efficient mutual funds.

Invest in Series EE U.S. Savings Bonds. The accumulated interest income from these bonds is tax-deferred until cashed in, meaning no kiddie tax applies if the bonds are cashed in when the child is exempt from the kiddie tax.

Use a Section 529 College Savings Plan. Withdrawals from a Section 529 plan account are federal-income-tax-free, provided they're used for qualifying education expenses.

Invest in life insurance products. Investment accounts included in life insurance products such as universal life policies allow tax-deferred accumulations and can be borrowed against for college costs.

Generate earned income. The kiddie tax does not apply to children aged 18-23 if their earned income exceeds 50 percent of their support for the year.

The QSEHRA Health Plan

If you're a small employer (fewer than 50 employees), you should consider the Qualified Small Employer Health Reimbursement

Arrangement (QSEHRA) as a good way to help your employees with their medical expenses.

If the QSEHRA is indeed going to be your plan of choice, then you have three good reasons to get that QSEHRA plan in place on or before October 2, 2023. First, this avoids penalties. Second, your employees will have the time they need to select health insurance. Third, you will have your plan in place on January 1, 2024, when you need it.

One very attractive aspect of the QSEHRA is that it can reimburse individually purchased insurance without subjecting you to the $100-a-day per-employee penalty that generally applies to the employer that reimburses employees for individually purchased insurance. The second and perhaps most attractive aspect of the QSEHRA is that you know your costs per employee. The costs are fixed—by you.

Eligible employer. To be an eligible employer, you must have fewer than 50 eligible employees and not offer group health or a flexible spending arrangement to any employee. For the QSEHRA, group health includes excepted benefit plans such as vision and dental, so don’t offer them either.

Eligible employees. All employees are eligible employees, but the QSEHRA may exclude

- employees who have not completed 90 days of service with you,
- employees who have not attained age 25 before the beginning of the plan year,
- part-time or seasonal employees,
- employees covered by a collective bargaining agreement if health benefits were the subject of good-faith bargaining, and
- employees who are non-resident aliens with no earned income from sources within the United States.

Dollar limits. Tax law indexes the dollar limits for inflation. The 2023 limits are $5,850 for self-only coverage and $11,800 for family coverage. For part-year coverage, you prorate the limit to reflect the number of months the QSEHRA covers the individual.