

Family Business Tax Savings

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Much has been said and written about nepotism, especially in government and business. However, there is no written rule that would prevent any commercial bird breeder from hiring a spouse, children or other family members to work in their business — there may even be tax advantages.

Many bird breeders are already in business with their spouses, whether they are aware of it or not. Any married couple in business may do so innocently, not aware that our laws and our tax rules consider them jointly liable for the income and debts of the captive bird-breeding operation. Even in those situations where the married couple is aware of their liability and may have formalized the relationship by incorporating the bird-breeding business or forming a legal partnership, quite a few potential pitfalls remain for the unwary.

Under our complex and often confusing tax rules, there is no one "right" way to own the bird-breeding operation. The choices range from sole proprietorships, to partnerships and even two choices of corporations, regular and the small business or 'S' corporation, which is treated much in the same manner as a partnership for tax purposes. There is even the increasingly popular limited liability partnership (LLC), an entity offering the limited liability of a corporation and the pass-through tax effects of a partnership.

The legal question of liability of a spouse involved or not involved in the other spouse's business is one best left to local legal experts. In the tax arena, however, the subject of spouses and family members should be considered.

Spouses And Family Members Every bird breeder has different priorities. One breeder may be concerned with estate taxes some years down the road and believe that an incorporated bird-breeding operation will reduce that eventual estate tax bite. Another bird breeder and his or her spouse will be concerned with building up the required number of Social Security "quarters" for a spouse employed in the captive bird-breeding operation. Still another bird breeder may prefer to split the operation's current income among family members in order to reduce the bite of taxes.

Payroll Taxes And Self-Employment As a general rule, most bird breeders operating as sole proprietorships are liable for Social Security (FICA) as well as income tax withholding — even on wages paid to a spouse working in the captive bird-breeding business. Wages that a commercial bird breeder pays to his or her child working in the business are subject to income tax withholding, but exempt from FICA if the child is under the age of 18.

Keep in mind that mere ownership or joint ownership of business property does not automatically qualify any spouse for self-employment tax purposes. Thus, if a bird breeder and spouse are personally operating a business that they hold as joint tenants, the net profits are, generally, all treated as one partner's net earnings from self-employment.

Ordinarily, any individual who owns a bird breeding operation or business may create a "working family" by employing his or her spouse and paying the spouse a salary. Employing one's spouse can be an extremely attractive method for splitting the family's income in such a manner as to take full advantage of our tax system.

If handled properly, the employer gets a tax deduction for the compensation paid to a spouse, while the spouse receives taxable cash income and, in some cases, other economic benefits such as insurance coverage, pension plans, etc. with no or low tax price to the bird-breeding business.

Obviously, no employer can claim a legitimate income tax deduction if his or her spouse does not actually perform services for the commercial breeding operation. Nor can a tax deduction be taken if the services rendered bear no reasonable relationship to the amount of compensation paid. What's more, in order for that spousal compensation paid to be tax deductible in full by the employer, it must also be reasonable.

In order to be considered as "reasonable" under our tax rules, the compensation paid to the spouse must be in accord with the prevailing rate of compensation for comparable positions with comparable employers in the local area. In the event that the compensation paid is determined by the IRS to be excessive, the employer's deduction will be lost to the extent that the amounts paid exceed reasonable compensation.

Another tax consequence of "spreading" the operation's income between a husband and wife is to reduce the self-employment tax that the bird-breeding operation's owner must pay on his or her own self-employment income. This so-called "income-dividing" is subject to the reasonable compensation rules. But, assuming the operation's burden of proof can be met, the reduction of combined family employment tax liability will be, once again, substantial.

Remember, however, that the employee-spouse who is not covered under the Social Security Act will not be earning credits for the normal Social Security benefits as do other compensated employees. In addition, the self-employed spouse with reduced earnings will be compiling proportionately fewer Social Security retirement benefits for him- or herself unless he or she is earning enough to pay the maximum in Social Security taxes for the year (\$76,200 maximum earnings base for 2000).

PartnersWhere the spouse is a partner in a commercial bird-breeding partnership, the partnership entity is not legally required to withhold income tax from any distributions made to that partner. However, that partner may be subject to self-employment tax on any distributions.

Under our tax rules, a partnership does not actually exist where a spouse who assists in the bird-breeding business does not actually participate in, or have a right to participate in, the management of the business — even where profits from the breeding partnership are treated as family funds.

As a rule, a person working as an employee for a partnership in which his or her spouse is a partner is considered to be an employee of the partnership, not of the spouse. And Social Security taxes must be paid on every employee's wages.

While there is not a substantial income tax advantage for any bird breeder forming a husband/wife partnership simply to shift the bird breeding operation's income from one spouse to another, this type of partnership may be desirable for another reason. Keep in mind that a husband/wife partnership entitles the so-called "non-working" spouse to Social Security retirement benefits as a result of the self-employment tax payable on partnership income. The IRS has agreed that such partnerships are valid for this purpose.

Although shareholders of a so-called "S" corporation are treated much in the same manner as partners, they are not subject to the self-employment tax on their share of the S corporation's ordinary income that is attributable to the operation of the bird-breeding business.

Similarly, when it comes to determining the applicability of Social Security tax to employment, a person working for a regular corporation in which his or her spouse owns stock is considered under our tax rules to be an employee of the corporation, not of the spouse. Remember, a corporation is considered to be a completely separate, taxpaying entity for tax purposes. In fact, this is true even in those situations where the spouse is the sole shareholder of the corporation.

The potential problem of qualifying for Social Security benefits at some future date is only one of the long-range factors that must be considered by family owned and/or operated bird breeding businesses. Even further down the line (hopefully), is the estate tax question.

Estate TaxesThe necessary trappings of passing the ownership of a family bird breeding business to the surviving heirs using such devices as wills, trusts and estates, are best handled by legal experts. Unfortunately, our tax laws exert control over the commercial bird breeding business entity by dictating how it must be handled upon the death of one or both spouses. Those tax laws have placed a ceiling on the amount which one spouse may receive, tax-free, upon the death of the other spouse.

Thus, a captive bird-breeding operation owned solely by one spouse would be passed in its entirety to the other spouse (ignoring wills, insurance and many other factors). The full value of that business would become part of the bird breeder's estate and be taxed accordingly. If, however, the spouse were a joint partner or joint shareholder in the bird breeding operation, only part of the business would be included in the estate and subject to estate taxes.

Married couples in business are a reality, whether the bird-breeding operation's owner realizes it or not. In reality, many bird breeders are not aware that their own business may be operating in this manner. In order to both profit and to avoid the potential pitfalls, planning, early and often as things change or the family bird breeding business grows, is essential for a good and profitable working relationship-and a low tax bill.

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