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Reduce Self-Employment Taxes by Renting from Your Spouse

If you are a sole proprietor, you know that the 15.3 percent self-employment tax can eat up your profits in a hurry.

You may be able to use a simple strategy to ease this tax burden.

If you own an office building or other assets, you can set up a rental arrangement with your spouse that could significantly cut your self-employment taxes.

How the Strategy Creates Cash

Suppose you operate a sole proprietorship and you earn $100,000 of net income.

You must report your income on Schedule C of your tax return, which creates a self-employment tax liability of $14,129.55.[1]

Here's how the rental strategy can help. You give the office building to your spouse, who then rents the office space back to you. To do this, you must have a valid non-tax purpose for the transaction, as we explain later.

You pay your spouse $2,000 rent each month (the fair rental value of the building), which moves $24,000 off Schedule C and onto Schedule E.

Schedule E, unlike Schedule C, does not give rise to self-employment taxes.

Thus, this strategy reduces your self-employment income by $24,000, which puts an extra $3,391.09 of cash in your pocket at the end of the year.[2]

The Legal Authority

The tax court approved this arrangement in the *Cox* case. In *Cox*, an attorney rented an office space that he co-owned with his spouse. The court granted the taxpayer his Schedule C deduction even though[3]

- the spouses filed a joint tax return and the strategy created a tax benefit.

The IRS directs its auditors to recognize *Cox*. However, the IRS guidance indicates that the IRS will not accept this transaction unless you can show a valid business or non-tax purpose for the transfer and leaseback of your property.[4]

Court cases also require a valid non-tax purpose for giving the property to your spouse.[5]

Why Your Spouse Plays an Important Role

You can deduct rent from Schedule C only for payments relating to property that you *do not own*. In *Cox,* the court ruled that the spouses each owned a 50 percent share of the property. Thus, Mr. Cox could deduct 50 percent of the rent payments.[6]

For you, this means you can use the rent-from-your-spouse strategy if

- you co-own property with your spouse or
- your spouse owns the property outright.

When your spouse owns 100 percent of the property, you deduct 100 percent of the rent payments and therefore increase your tax savings.

Note. There are no gift tax, estate tax, or income tax consequences when you give property to your spouse.[7] However, keep in mind that giving your spouse full ownership of your business property may have consequences outside of tax, such as in a divorce proceeding.

Community Property States

In community property states, you and your spouse each own a 50 percent share of most types of property you acquire during the marriage, regardless of whose name appears on the title.

If you live in one of the community property states, you must take extra steps to give your spouse 100 percent ownership of any asset.

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

The Right Business Purpose

What is a good business purpose for renting your office from a separate entity? Limited liability.

Many business owners put their real estate in a separate LLC for liability protection reasons. The IRS recognizes that liability protection is a common and legitimate reason to create a self-rental arrangement.[8]

Giving full ownership to your spouse requires an additional, non-tax purpose. For example, you might transfer the property to ensure that your spouse has a separate income stream, including the right to take out loans on the property and sell the property as he or she deems fit.

Planning tip. Create a document at the time of the transaction explaining your business and personal reasons for transferring your property to your spouse.

Tips to Make This Strategy Work

You have to respect all the formalities of the lease contract that you enter into with your spouse. You must treat the lease as if you were renting from an unrelated landlord, and your spouse must act as if he or she is the owner of the property.[9]

Here is a list of tips to follow:

1. Find the fair rental value of the property and pay no more or less than this amount, taking into account your ownership in the property. For example, if you own 50 percent of the property, pay your spouse 50 percent of the fair rental value.

2. Create a written lease appropriate for a commercial lease. You can find lease templates online.

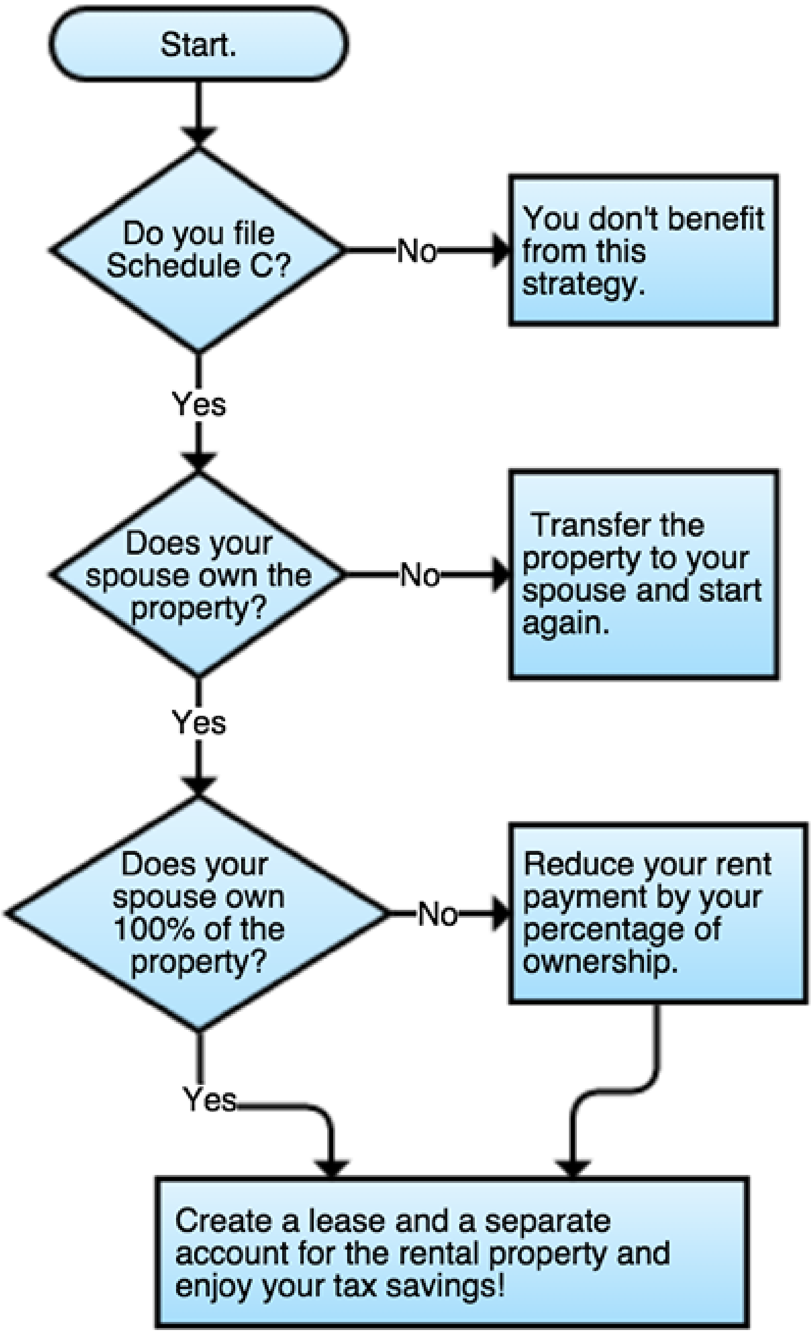
3. Make actual payments to your spouse.

4. Your spouse should deposit the funds into a separate checking account for the rental property.

5. Your spouse should pay all expenses and debts relating to the property. (If you have an ownership stake in the property, you pay your share of the expenses and debts.)

6. Give your spouse a Form 1099-MISC for the rent that you paid during the year.

Flowchart



Takeaways

By renting your office space from your spouse, you generate thousands of dollars in self-employment tax savings.

The strategy works by moving income away from your Schedule C, which creates self-employment tax, and onto your joint return Schedule E, which does not.

To do this correctly, you need to remember three main rules:

1. Your spouse needs to have an ownership stake in the property. Ownership of 50 percent is good, and 100 percent is better.

2. If you transfer the property to your spouse, make a note in your records regarding the non-tax purpose of the transfer.

3. You and your spouse must treat the rental arrangement as if you are unrelated businesspeople. That means a contract, a fair rental price, and actual payment of rent.

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1 $100,000 x 15.3 x .9235 = $14,129.55. The .9235 figure comes from Schedule SE, which gives you a small deduction when computing your self-employment tax.
2 $24,000 x .153 x .9235 = $3,391.09. Note that the self-employment tax rate drops when you exceed $126,691.93 of self-employment income as a sole proprietor (in 2014, based on the current wage base). This means you get less tax savings from this strategy when your income exceeds that amount.
3 D. Sherman Cox, TC Memo 1993-326.
4 IRM 4.10.13.9; MSSP Training Guide, Independent Used Car Dealers, Chapter 6, Expense Issues, Rent Expense.
5 Finley v Commr., 255 F.2d 128 (CA10).
6 In Cox, the two parties each owned 100 percent of the property under state law. However, for tax purposes the court treated each spouse as owning 50 percent.
7 IRC Sections 1041; 2523.
8 IRM 4.10.13.9.
9 See Finley v Commr., 255 F.2d 128 (CA10).