

## THE WORKING SPOUSE: NEW OPPORTUNITIES FOR INCREASED RETIREMENT PLAN CONTRIBUTIONS

**Spouse on Payroll** - Many closely held businesses are owned by an individual (the "Owner") whose spouse (the "Spouse") works in the business on a substantially full-time basis (for purposes of this discussion, it is assumed that Spouse works at least 1,000 hours per year). Primarily because of the expenses attributable to FICA (currently 7.65% of compensation, paid both by the employee and the employer), it may not have been economical to put the Spouse on the payroll, or Spouse may have been provided with nominal compensation (perhaps enough to fund an IRA), despite performing services that would warrant substantial compensation from any other employer. Even the benefit of Spouse's participation in the company's retirement plan would not be sufficient to offset the FICA expense:

**Example:** In 2001, Owner's compensation is \$250,000. Spouse performs services (e.g., as office manager) that would be worth \$50,000 for any other employer. Owner gets a retirement contribution of \$35,000, taking into account only compensation up to \$170,000. If Spouse had been paid \$50,000 (thus reducing Owner's compensation to \$200,000), and if Spouse had participated in the retirement plan, the maximum retirement plan contribution that could have been made for Spouse would be \$12,500 (25% of Spouse's compensation). Assuming a 40% tax bracket for Owner and Spouse, the plan contribution for Spouse would save \$5,000 in income taxes. However, the additional FICA expense attributable to Spouse's compensation would be \$6,400 (7.65% x 2 - 1.25% x 2, Medicare tax already being paid on Owner's full compensation). Accordingly, the payment of compensation to Spouse, even with Spouse's full participation in the company's retirement plan, results in a \$1,400 increase in aggregate taxes.

**Effect of EGTRRA** - The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made significant changes to the tax laws governing qualified retirement plans. These changes include the following provisions, all of which have become effective for plan years beginning in 2002:

- (a) Increase in the maximum dollars allocable to a participant in a defined contribution plan from \$35,000 to \$40,000 (IRC Section 415 dollar limit).
- (b) Increase in the maximum percentage of compensation allocable to a participant in a defined contribution plan from 25% to 100% (IRC Section 415 percentage limit).
- (c) Increase in the maximum amount of compensation taken into account for retirement plan purposes from \$170,000 to \$200,000.
- (d) Increase in the percentage of aggregate compensation deductible under a profit sharing plan from 15% to 25%.
- (e) Increase in the maximum calendar year amount which may be deferred under a 401(k) plan from \$10,500 to \$11,000 (\$12,000 for a participant who is at least 50 years old).
- (f) Exclusion of 401(k) salary deferrals from deductible limitations (described in (d) above).

Considering all of these changes, there is a significant financial incentive to putting Spouse on the company payroll in 2002. **Using a 401(k) profit sharing plan, Owner and Spouse may each obtain a \$40,000 allocation (\$41,000 if they are at least age 50).** Despite the \$6,400 increase in FICA costs, the tax savings to the couple on each \$40,000 contribution would be \$16,000, resulting in a \$9,600 overall tax savings by shifting income from Owner to Spouse.

**Caveats** - Before assuming the favorable results in the foregoing example, a careful analysis must be made, taking into account the following:

(a) Spouse must satisfy all eligibility requirements applicable to participants in the plan in general. Accordingly, if the plan has a one year of service eligibility requirement, and Spouse has never worked in the business before, these tax savings will not be available in 2002. On the other hand, if Spouse has performed the services but has never been compensated for such services, Spouse may be deemed to have met the minimum eligibility requirements.

(b) In order to have \$40,000 contributed on behalf of Spouse, and with a 401(k) program being utilized for at least a portion of that contribution, Spouse's income will have to be grossed up above \$40,000 for FICA purposes, and, if applicable, Pennsylvania state and local income taxes.

(c) The examples above assume that Owner and Spouse are the only participants in the plan. These calculations may or may not be valid if there are other participants:

(1) In order for Spouse to be able to defer \$11,000 in a 401(k) plan, there most probably would have to be a 401(k) safe harbor election in effect. In the absence of such election, Spouse's deferral of \$11,000 on \$50,000 of compensation results in a 22% actual deferral percentage, which will almost certainly cause the plan to fail any required discrimination testing. A 401(k) safe harbor election (see our prior newsletters dated November 1998, February 1999, November 1999 and November 2001) will eliminate all discrimination testing, an important hurdle to overcome.

(2) Providing a \$29,000 employer contribution for Spouse (assuming \$11,000 comes from a 401(k) deferral) would require a substantial contribution for other participants, possibly resulting in deductibility problems (as well as a cash expense that most employers would not accept for non-family members).

(3) Even in the absence of a substantial employer contribution for Spouse, in a cross-tested (new comparability) plan, Spouse's ability to defer \$11,000 on \$50,000 of compensation may adversely impact the average benefits percentage test and may limit Owner's ability to receive a maximum employer profit sharing allocation.

**Conclusion** - While a detailed discussion of these points is beyond the scope of this memorandum, an analysis of the effect of Spouse's participation must be undertaken to determine the optimal basis for Spouse's participation in the retirement plan. As always, we remain available to discuss your clients' situations with you.



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