

Saving Taxes by Employing Family Members

As the owner of a business, you should be aware that you can save family income and payroll taxes by putting junior family members on the payroll. You may be able to turn high-taxed income into tax-free or low-taxed income, achieve social security tax savings (depending on how your business is organized) and even make retirement plan contributions for your child. Here are the key considerations.

Turning high-taxed income into tax-free or low-taxed income. You can turn some of your high-taxed income into tax-free or low-taxed income by shifting some of your business earnings to a child as wages for services performed by him or her. The work done by the child must be legitimate, and the amount you pay the child must be reasonable for your business to deduct the wages as a business expense.

For example, suppose a business person operating as a sole proprietor is in the 35% tax bracket. He hires his 17-year-old daughter to help with office work full-time during the summer and part-time into the fall. She earns \$5,000 during the year (and doesn't have earnings from other sources). The business person saves \$1,750 (35% of \$5,000) in income taxes at no tax cost to his daughter, who can use her \$5,000 standard deduction for 2005 to completely shelter her earnings.

The business person could save an additional \$1,400 in taxes if he could keep his daughter on the payroll for a longer period and pay her an additional \$4,000. She could shelter the additional amount from tax by making a tax-deductible contribution to her own IRA.

And family taxes are cut even if the child's earnings exceed his or her standard deduction and IRA deduction. That's because the unsheltered earnings will be taxed to the child beginning at a rate of 10%, instead of being taxed at the parent's higher rate.

Keep in mind that bracket-shifting works even if the child is under age 14 (although you'd probably be paying less for a younger child's labor). The kiddie tax only causes a younger child's investment income in excess of \$1,600 (for 2005) to be taxed at the parent's marginal rate. It has no impact, however, on the child's wages and other earned income, which can be sheltered by the child's standard deduction.

What about income tax withholding? Your business probably will have to withhold federal income taxes on your child's wages. Usually, an employee can claim exempt status if he or she had no federal income tax liability for last year, and expects to have none for this year. However, exemption from withholding can't be claimed if (1) the employee's income exceeds \$800 and includes more than \$250 of unearned income (such as dividends), and (2) the employee can be claimed as a dependent on someone else's return. Keep in mind that your child probably will get a refund for part or all of the withheld tax when he or she files a return for the year.

Social security tax savings, too. If your business is not incorporated, you can also save

some self-employment (i.e., social security) tax dollars by shifting some of your earnings to a child. That's because employment for FICA tax purposes doesn't include services performed by a child under the age of 18 while employed by a parent. For example, let's say a sole proprietor who usually takes \$120,000 of earnings from the business pays \$5,000 to her 17-year-old child in 2005. The sole proprietor's self-employment income would be reduced by \$5,000, saving her \$145 (the 2.9% HI portion of the self employment tax she would have paid on the \$5,000 shifted to her daughter). This doesn't take into account a sole proprietor's income tax deduction for one-half of his or her own social security taxes.

A similar but more liberal exemption applies for FUTA, which exempts earnings paid to a child under age 21 while employed by his or her parent. The FICA and FUTA exemptions also apply if a child is employed by a partnership consisting solely of his parents.

Note that there is no FICA or FUTA exemption for employing a child if your business is incorporated or a partnership that includes non-parent partners. However, there's no extra cost to your business if you're paying a child for work you'd pay someone else to do, anyway.

Retirement benefits. Your business also may be able to provide your child with retirement benefits, depending on the type of plan it has and how it defines qualifying employees. For example, if it has a simplified employee pension, a SEP contribution can be made for the child up to 15% of his or her earnings. The child's participation in the SEP won't prevent the child from making tax-deductible IRA contributions as long as adjusted gross income (computed in a special way) is below the level at which deductions for IRA contributions begin to be disallowed. For 2005, that figure is \$50,000 for a single individual.

If you have any questions about how these rules apply to your particular situation, please don't hesitate to call. Also keep in mind that some of the rules about employing children (such as the maximum amount they can earn tax-free) change from year to year, and may require your income shifting strategy to change, too.

Sincerely,

John K. Ross IV

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