

Tax Advantages of Employing Your Children

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As the owner of a business, you should be aware that you can save family income and payroll taxes by putting your children on the payroll. You may be able to turn high-taxed income into tax-free or low-taxed income, achieve social security tax savings, and even make retirement plan contributions for your child. The following are some 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. In order for your business to deduct the wages as a business expense, the work done by the child must be legitimate and the child's salary must be reasonable.

For example, suppose a business owner operating as a sole proprietor is in the 35% tax bracket. She hires her 17-year-old child to help with office work - full-time during the summer and part-time into the fall. The child earns \$5,450 during the year and doesn't have earnings from other sources. The business owner saves \$1,907 (35% of \$5,450) in income taxes at no tax cost to the child, who can use the \$5,450 standard deduction for 2008 to completely shelter the earned income. The business owner could save an additional \$1,400 in taxes if she could keep the child on the payroll for a longer period and pay an additional \$4,000 in wages. The child could shelter the additional amount from tax by making a tax-deductible contribution to an IRA. 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 subject to the "Kiddie Tax". The Kiddie Tax only causes a child's investment income in excess of \$1,800 (for 2008) to be taxed at the parent's marginal rate. It has no impact on the child's wages and other earned income, which can be sheltered by the child's standard deduction. For children under age 18, there is no earned income escape hatch from the Kiddie Tax. But in all cases, earned income can be sheltered by the child's standard and other deductions, as noted above, and earnings in excess of allowable deductions will be taxed at the child's low brackets.

Social security tax savings, too. If your business is not incorporated – for example, a sole-proprietorship - you can also save some 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 \$5,450 to her 17-year-old child in 2008. The sole proprietor's self-employment income would be reduced by \$5,450, saving her \$158 (the 2.9% Medicare tax portion of the self employment tax she would have paid on the \$5,450 shifted to her daughter).

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 25% of his or her earnings but the contribution cannot exceed \$46,000 for 2008. The child's participation in the SEP won't prevent the child from making tax-deductible IRA contributions as long as adjusted gross income is below the level at which deductions for IRA contributions begin to be disallowed.

Please consult your tax professional before employing any of the above. Every individual and business has its own unique set of circumstances to consider when making such decisions.