

Employing Your Children in Your Business

Hiring your children to work in your business can be a very astute tax move for you and a nice way to save for retirement for your children.

Employing a business owner's children to work in the business during breaks, weekends or afternoons is an often overlooked benefit. It permits a business deduction for the compensation and shifts income to lower income family members while creating earned income that then allows those family members to make IRA contributions. Making a traditional IRA contribution for the child, coupled with the standard deduction means that \$7,700 in 2002 can be paid with no income tax cost to the child/employee. Alternatively, if the child makes a Roth IRA contribution, \$3,000 less income (\$4,700 for 2002) can be earned tax free, but the child has a great head start on building a tax-free source of retirement funds.

The employer/parent gets a deduction for the compensation as a business expense, thus taking it off of his/her gross income. The same holds true for older parents who are in a lower tax bracket than you. The wages paid to your children are subject to their tax rate which is generally much less than your tax rate.

The employer is also not subject to social security taxes on wages paid to the child if the employer/parent is a sole proprietorship or partnership owned solely by the child's parents and the child is age 17 or younger. Normally, a business pays 7.65 percent of each employee's salary in Social Security and Medicare taxes and withholds another 7.65 percent from the employee for the employee's share of those taxes. By not paying or withholding FICA from your child's paycheck, you save 15.3 percent.

Example: If Bob hires his daughter Sharon to work 15 hours per week at \$5.15 an hour, he'll save about \$614.60 over the course of the year ($15 \times 52 \times \$5.15 \times .153$).

A child's earned income is also not subject to the kiddie tax. The kiddie tax is a tax that arises due to a special set of rules which apply to individuals under the age of 18.

It should come as no surprise that the IRS is quick to challenge such arrangements, if the compensation is unreasonable. However, there are a number of steps that can minimize the success of an IRS challenge.

- Compensation should be comparable to market.
- General payroll rules should apply to family members (i.e. family members should be paid regularly, timesheets maintained if required of other similar employees, etc.).
- Child employment or labor laws should be followed.
- Duties and responsibilities should match child's age and abilities.

If a child has performed services for the business in the past, for which the child has not yet been compensated, the parents/employer should consider adding that compensation to the current pay. However, the services provided, as well as the computation of the compensation, should be carefully documented.