Hiring your Children to work in your Business

By Peter Jason Riley

What Can they Do – This is generally the opening question in this discussion. Obviously, the type of work for which you hire your child has to match their ability. Younger kids might sort mail, stuff envelopes and other simple tasks, appear in advertising material while older ones could take on jobs like data entry or handling customer correspondence. Keep pay rates reasonable, and keep track of time as carefully as you would with a non-family member, paying wages on some kind of regular schedule. Remember under the Internal Revenue Service code you must be paying your children for a job that if they were not available you would be paying someone else to do, i.e. it must be a ***real job***.

Is there work for which you definitely can't hire someone under 18? Yes? lots of it. The Fair Labor Standards Act, a federal law, outlines what types of jobs kids are allowed to do, and at what ages. The point of the law is to protect young workers, so it speaks to issues like type of work, breaks and maximum hours per week. Many states add still more restrictions to the federal law. By sure to check with an expert in your states labor laws if you have any questions in this area.

Working for the family business is more than just a refuge from a poor economy for children seeking summer employment and recent grads beginning their careers. It can be a shrewd strategy for generating tax-savings. By paying their children reasonable wages to do legitimate work, business owners can convert their high-taxed income into tax-free or low-taxed income.

The Standard Deduction - For example, the self-employed owner of an accounting firm in the 35% tax bracket for 2006 hires her 16-year-old son to do office work full-time during the summer and part-time during the fall. She pays him $5K for the year. Since the $5K would otherwise be paid to the business owner and taxed at 35%, she saves $1,750 in federal income taxes (35% of $5K.) Since her son receives a $5,150 standard deduction for 2006, his earnings will be completely federal tax free. Thus, the $5K that would have been taxed at the business owner's 35% rate ends up being completely tax free simply by hiring her child, an instant tax savings of $1,750.

Tax Bracket-shifting - A family can generate even more tax savings if the child earns more than his or her standard deduction in the year, because the child's unsheltered earnings will still be taxed at a considerably lower tax rate than the business owner's earnings. While the parent's earnings might be taxed at 35%, the starting tax rate on the child's unsheltered earnings is only 10%. Consequently if the parent were able to justify the child earning up to $11k in 2006 the first $5,150 would be tax free federally and the next $5,850 would only be taxed at 10% or $585. Continuing the above example if the self employed accountant was able to justify paying her son $11K instead of $5K she would lower her income by $11K @ her 35% tax rate ($3,850 in federal taxes) and her son would only paid $585, an instant tax savings of $3,265.

Begin Retirement Planning Early. Another tax-free strategy is placing a portion of the child's earnings in a retirement plan. A child can make a tax-deductible contribution of up to $4K to his or her own IRA. For example, if a child works past the summer and into the school year, she can receive the $5,150 protected by her standard deduction and contribute up to $4K into a ROTH IRA. The family business may even be able to provide her with additional retirement plan benefits depending on its type of retirement plan, the child's age, and the number of hours he or she works.

FICA & FUTA Exemptions. Tax exemptions may flow to a parent who is a sole-proprietor employing his or her children. Employment for FICA tax purposes does not include services performed by a child under the age of 18 while employed by a parent. Code Sec. 3121(b)(3)(A). For example, consider a sole-proprietor who normally takes $120,000 of earnings from the business but pays his daughter $5K during 2006. His self-employment income is reduced by $5K, saving him an additional $145 (the 2.9% portion of the self-employment tax he would have paid on the $5K shifted to his daughter.)

This does not take into account a sole proprietor's income tax deduction for one-half (1/2) of his or her own social security taxes. This is in addition to the $382.50 (.0765 x $5K) in employee FICA the child saves by working for a parent instead of someone else. A similar but more liberal exemption applies for FUTA.

Earnings paid to a child under age 21 while employed by his or her parent are exempt from FUTA. It is worth noting that both the FICA and the FUTA exemptions apply if a child is employed by a partnership consisting solely of the child's parents. These exemptions do not apply if the business is incorporated or the partnership includes non-parent partners. Under those circumstances, the child would be subject to the same rules as any other employee.

College Credits – as your children reach college age there can even be more compelling reasons to keep them on the company books. If the parents are in high income brackets their ability to utilize college credits evaporates as might their exemption deduction for the child. By shifting enough income to the child, the children may be able to file an independent tax return (i.e no longer a dependent on the parents return), claiming their own exemption and using the available college credits. In 2006 if a college student, eligible for the HOPE credit earned $23K and was able to file a as a single taxpayer using his or her own exemption as well as the HOPE credit their net federal income tax liability would be only $129! (*The rules for a college student to be able to file as an independent, single taxpayer are complicated so be sure to review these rules carefully with a tax professional before moving forward with this strategy.*)

These strategies outline some of the tax benefits of putting children to work in the family business. Careful planning can help ease the tax burdens shouldered by parents and children.