Tax benefits of putting junior family members on the payroll

Dear Client:

As a business owner, 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.

In addition, employing a child age 18 (or if a full-time student, age 19-23) may be a way to save taxes on the child's unearned income, as explained below.

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. 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 39.6% 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 $6,100 during the year (and doesn't have any other earnings).

The business owner saves $2,415.60 (39.6% of $6,100) in income taxes at no tax cost to his daughter, who can use her $6,350 standard deduction (for 2017) to completely shelter her earnings. The business owner could save an additional $2,178 in taxes if he could keep his daughter on the payroll longer and pay her an additional $5,500. She could shelter the additional income from tax by making a tax-deductible contribution to her own 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 for a child who is subject to the kiddie tax, which causes the child's investment income in excess of $2,100 for 2017 to be taxed at the parent's marginal rate. The kiddie tax has no impact on the child's wages and other earned income.

The kiddie tax doesn't apply to a child who is age 18 or a full-time student age 19 through 23, if the child's earned income for the year exceeds one-half of his or her support. Thus, employing a child age 18 or a full-time student age 19-23 could also help to avoid the kiddietax on his or her unearned income.

For children under age 18, there is no earned income escape hatch from the kiddietax. 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 rates.

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 $1,050 for 2017, and includes more than $350 of unearned income (such as dividends) for 2017, 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 isn't 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 services performed by a child under the age of 18 while employed by a parent isn't considered employment for FICA tax purposes.

For example, let's say a sole proprietor who usually takes $120,000 of earnings from the business pays $5,700 to her 17-year-old child. The sole proprietor's self-employment income would be reduced by $5,700, saving her $165.30 (the 2.9% HI portion of the self employment tax she would have paid on the $5,700 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 (unemployment) tax, 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 (SEP), a contribution can be made for the child up to 25% of his or her earnings but the contribution cannot exceed $53,000 for 2016. 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 2016, that figure is $61,000 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.

Very truly yours,

Cohen & Grieb, P.A.