

## Tax benefits of putting junior family members on the payroll

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. Starting next year when changes broadening the "kiddie tax" first go into effect, in many cases, employing a child age 18 (or if a full time student, age 19-23), can save taxes on his or her 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. 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 \$5,350 during the year (and doesn't have earnings from other sources).

The business person saves \$1,872.5 (35% of \$5,350) in income taxes at no tax cost to his daughter, who can use her \$5,350 standard deduction for 2007 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 18 and thus potentially subject to the kiddie tax for 2007. For this year, the kiddie tax only causes an under age 18 child's investment income in excess of \$1,700 (for 2007) 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. Starting next year, due to a recent tax law change, the kiddie tax will be expanded to apply where:

- a child who is age 18 or a full time student age 19 through 23;
- the child's earned income for the year doesn't exceed one-half of his or her support;
- the child has more than the prescribed amount of unearned income (i.e., \$1,700 plus any inflation adjustment for 2008);
- the child has at least one living parent at the close of the tax year; and
- the child doesn't file a joint return for the tax year.

Thus, starting next year, employing a child age 18 or a full-time student age 19-23 could also help to avoid the kiddie tax on his or her unearned income. Note, however, that for

children under age 18, there is no earned income escape hatch from the kiddie tax this year or in future years. But remember, 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.

**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 \$300 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 \$5,350 to her 17-year-old child in 2007. The sole proprietor's self-employment income would be reduced by \$5,350, saving her \$155.15 (the 2.9% HI portion of the self employment tax she would have paid on the \$5,350 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 25% of his or her earnings but the contribution cannot exceed \$45,000 for 2007. 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 2007, that figure is \$52,000 for a single individual.

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.