

Business Owners: Hiring Your Kids to Cut Taxes

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Do you ever get the feeling that your kids are taking you to the cleaners? We're not talking about the cost of necessities such as daycare, living space, food, school supplies, and clothing. It's those discretionary expenses, like cell phone service, sports leagues, music lessons, games and entertainment, outings with friends, and car and driving expenses.

If you're paying for all that, you're doing so with after-tax dollars. And you should be putting the brakes on that habit immediately if not sooner.



As a small-business owner, you're allowed to hire your family members (including children, grandchildren, parents, siblings, nieces, nephews) to work for your business, pay them a fair and reasonable wage, and then have *them* pay for their own bells and whistles. In addition, they can sock away some of that money to use later for college or to buy a car, pay for their own lavish wedding, start a business or support the start-up costs associated with starting a family, retire, pay for college or whatever else they decide to do when they're ready to do it.

Even better, you won't have to pay income tax or self-employment tax on the wages you pay them, and chances are good, in the case of your children, that neither will they. Also, when you hire your own children to work for you, the wages you pay them are exempt from FICA (Social Security and Medicaid) withholdings and federal unemployment (FUTA) tax unless your business is incorporated. Some restrictions apply, of course, but this tax loophole is perfectly legal and something that all small-business owners with children should consider.

So, How Does This Work?

Here's how it works: You hire your child and the business pays them. Their first \$12,400 of earned income is taxed at zero. That's because \$12,400 is the standard deduction for a single taxpayer, even if you claim them as your dependent. Their next \$9,876 of taxable income is taxed at just 10 percent.

Here are the basic rules:

- Your child must be at least seven years old.
- You must have a written contract with your child stipulating the work to be done and how wages will be calculated and paid.
- You have to pay a "reasonable" wage for the work they do – technically what you'd pay any non-related person for the same work, with an adjustment made for the child's age and experience. So, if your 14-year-old cleans the pools for your rental properties, pay her what a pool service would charge. If your 17-year-old helps keep your books, pay him a bit less than a freelance bookkeeper might charge. If your teenager helps you keep up on the latest technologies, pay her about the same as you would pay an IT person.
- To audit-proof your return, create a job description and keep a timesheet. However, nothing in the tax code requires that anyone you hire actually does the work you hired that person to do. The IRS doesn't care if you want to pay people for doing nothing. However, as a parent, you probably want to require that your child perform a reasonable amount of work for the money. Taking on responsibilities at a young age isn't a bad benefit of this approach.
- Pay by check or electronic transfer (not cash), so you can document the payment.
- You must deposit payments into an account in the child's name, but it doesn't have to be their pizza-and-party fund. It can be a Roth IRA for decades of tax-free growth, a Section 529 college savings plan, or a custodial account that you control until they turn 21. Now, you can't use money in a custodial account for your obligations of parental support, but private and parochial school, extracurricular activities, video games, and phone plans aren't obligations of parental support.
- You must issue your child a W-2 at the end of the year.

Recognizing the Benefits

Let's say your teenage son wants to spend two weeks at tennis camp. You can earn the enrollment fee yourself, pay tax on it, and pay for his camp enrollment and commissary fees with after-tax dollars. Or you can pay him to work in your business, deposit the payment in his custodial account, and then, as custodian, write the check to the tennis camp yourself. In a sense, hiring your son and putting him to work allows you deduct his tennis camp costs as a business expense.

Pro Tip: If you hire one of your children to work in an *unincorporated business* (a business that does not possess a separate legal identity from its owner – commonly referred to as a Schedule C or Self-proprietor business), you don't have to withhold for Social Security until the child turns 18. So, as you can see, this truly is tax-free money. You'll still have to deal with paperwork, like issuing a Wage and Tax Statement (W-2) at the end of your business' fiscal year. And you still must ensure that they report their income on their own tax return (if the income is enough to require them to file a tax return themselves). But as you can see, this is painless when you consider the money you'll save by taking advantage of this approach.

Finally, hiring your children to work for you might teach them a thing or two about the value of a dollar and how to manage their money. To further that effort, you might even consider starting a family investment club – something that helps your children learn how to make investment decisions, resulting in an education that will pay enormous dividends for the rest of their lives.

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