Hire Your Children To Ease Estate and Income Taxes

If you own a family business, you may be able to reduce your estate and also reduce income and payroll taxes by paying wages to your children. The work they perform must be real, and the amount of compensation you pay must be reasonable for the business to deduct the wages as a business expense.

How This Technique Works

Karen is a sole proprietor with business income of $50,000. She is in the 31% tax bracket and is married with two children aged 13 and 15. She hires her children to help with miscellaneous office work for the summer. Both children earn $3,500. Karen has removed $7,000 from her estate and saved $2,170 in income tax (31% of $7,000).

The children owe no income tax, because their standard deduction ($4,400 for 2000) exceeds their taxable income. Even if the children's taxable wages exceed their standard deductions, Karen still achieves a tax savings because the children's income is taxed at a beginning rate of 15%.

You might think this strategy won't work for children under age 14 because the kiddie tax (taxed on a child's income at the parent's tax rate) would apply. But this tax applies only to unearned income, such as dividends. The kiddie tax does not apply to a child's wages and other earned income.

More Savings For Unincorporated Businesses

Paying wages to a child also reduces the amount of self-employment tax owed by a parent who owns an unincorporated business. Employment for Social Security tax purposes does not include services a child under age 18 performs if employed by a parent.

For example, Steve employs his children (aged 12 and 16) and pays them wages of $3,500 each. He will reduce self-employment income by $7,000. The Medicare portion of self-employment tax is 2.9% for 2000.

The children's wages would save $203 in self-employment tax (2.9% of $7,000). And earnings a parent pays a child under age 21 are exempt from FUTA. The FICA and FUTA exemptions also apply to a child employed by a partnership whose partners are solely his or her parents.

Explore Your Options

In addition to achieving income tax savings, reallocating income to a child provides several unique and often overlooked estate planning opportunities. It can also serve as a child's first financial and employment experience.

Please let us know if our professionals can help you take advantage of this or other ways to reduce your estate tax liability.

IRA Benefits to Children

Children employed by their parents may use Roth IRAs to begin saving for retirement or for their first home. Tax treatment of Roth IRAs differs from that of traditional IRAs in ways that make them particularly advantageous for children. Taxpayers cannot deduct contributions to Roth IRAs but they never owe tax on qualified distributions.

The child likely won't miss out on a deduction because his or her income will be less than the standard deduction and thus not taxable. And the Roth IRA contributions will have many years to grow tax-free.

A child's contribution to a Roth IRA will be limited to the amount of income he or she has earned, up to the maximum contribution of $2,000, including contributions to any other IRAs the child has.