

Reallocate Income to Children And Save Big on Taxes

If you are a business owner, you may be able to reduce your estate, income and payroll taxes by employing your children in your family-owned business. The work they perform must be real, and the amount of compensation paid must be reasonable for the business to deduct the wages as a business expense. Otherwise, you could be deemed to have made indirect -- which may be taxable -- gifts to the children.

Income Tax Benefits

Consider this example. Beth is a sole proprietor with net business income of \$50,000. Assume she is in the 31% income tax bracket and is married with two children ages 13 and 15. She hires her two children to help with miscellaneous office work during the summer. The children do not have any other sources of income. Both children earn \$3,500 during the summer. Beth has saved \$2,170 in income tax (31% of \$7,000) and shifted \$4,830 (\$7,000 - \$2,170) out of her estate. The children will not owe income tax because their standard deduction (\$4,300 for 1999) exceeds their taxable income. Even if their taxable wages exceed the standard deduction, they may still achieve a tax savings because their incomes should be taxed at the lowest rate of 15%.

You might think this doesn't apply to children under age 14 because their incomes are taxed at their parents' tax rate. This is often referred to as the "kiddie tax." But this applies only to unearned income, such as interest and dividends. It does not apply to a child's wages and other earned income.

Self-Employment Tax Savings

Assuming Beth is the owner of an incorporated business, paying wages to her children will also reduce self-employment tax. For example, by allocating this income to her children, Beth will have reduced her self employment income by \$7,000. The Medicare portion of the self-employment tax is 2.9% for 1999. The wages paid to the children will therefore result in an additional savings of \$203 in self-employment tax (2.9% of \$7,000). Such wages will not be subject to FICA and FUTA since exceptions are made for certain family employment situations. The FICA (which includes Social Security and Medicare) and FUTA exemptions also apply to a child employed by a partnership whose partners are solely his or her parents.

Your Children's Future

Children employed by a parent may also begin saving for retirement or for their first homes by using Roth IRAs. Contributions to a Roth IRA are limited to the amount of income earned. In the above example, each child could contribute the maximum \$2,000 to a Roth IRA every year. You may want to consider making a gift to your children to reward them for their efforts.

If you are already making annual exclusion gifts to your children to reduce your taxable estate, having them earn the money can also be used as an invaluable teaching tool to impart the value of working and earning.

Contributions to a Roth IRA are not deductible, but qualified distributions are excluded from gross income. One type of qualified distribution is a distribution for a down payment on a first home (up to a \$10,000 withdrawal).

Examine All Angles

In addition to achieving income tax savings, reallocating income to a child provides a unique estate planning opportunity to reduce your taxable estate without using any of your annual gift tax exclusion or applicable credit amount. But this technique may not be ideal in every situation. If you would like information about such estate planning techniques or to learn more about the other tax benefits of employing your children, please let us know. Our professionals can help you with this type of planning.