



## **HIRING FAMILY MEMBERS**

Putting family members on your business payroll can create some significant tax savings. Naturally, the IRS expects these family members to perform services for the business to justify the tax deductions. But the various IRS and state laws governing employees and tax obligations are much more liberal when you employ family members as opposed to outsiders, especially for certain forms of business organizations.

Is it possible you could employ your 12 year old child to help you clean up your office, do filing, etc. and write off this as a tax deduction in your unincorporated business? Yes. If you were to pay that child \$4,300 for the year, and your marginal federal/state tax bracket(including self-employment tax) were 45%, that could translate into a tax savings to you of \$1,912 per year.

If you have a corporation, could you hire your spouse, include the spouse in various fringe benefit and pension plans, and take a tax write-off for these business expenses? The answer again is Yes.

These are some of the possibilities that exist for a business owner. Properly handled, the hiring of family members can greatly reduce taxes in your business. Naturally, there are some variables that must be considered to determine overall tax saving possibilities. The three main ones are: the type of business entity you have; the relationship and/or age of the potential family member employee; and, whether or not certain types of business deductions are being used.

### **Type Of Business Entities**

For the most part, the two main business types that have the most impact on the possible benefits of employing family members are sole proprietorships and corporations.

#### **Sole Proprietorship**

A sole proprietorship—that is, an unincorporated business—can create some interesting tax-saving opportunities in the case where the business owner has children who could help out. In order to understand the possible tax savings, you should first know several "loopholes" that exist on the federal level in this regard.

Basically, a sole proprietor is allowed to hire his or her children even if the children are not of "legal" working age. In other words, is it possible you could hire your 9 year old to help out if it were feasible? According to federal law, it would be perfectly acceptable. Second, the law also states that the sole proprietor does not have to pay social security taxes on his/her children's wages if the children are under 18 years old—nor do the children have to pay it either.

Let's see how this could save you some significant tax dollars. Let's assume Business Owner A is currently paying income taxes at the rate of 28%. In addition, a sole proprietor must pay self-employment taxes on the profits as well. For the current 2000 year, that rate is 15.3% before adjustments—and approximately 14% in round numbers after adjustments. Thus, the overall marginal federal tax bracket in this case is 42%. That means 42 cents of taxes are being paid for every additional dollar being earned. From a tax write-off standpoint, it also means 42 cents of taxes would be saved for every additional dollar of deductions.



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Thus, if Business Owner A were to hire his/her child for the year, and pay that child a reasonable wage, the savings could be as high as 42 cents on every dollar paid out. Let's assume the child was paid \$2,000 for the year. The savings would be \$840. per year, every year the child was paid.

Will the child have to pay taxes on the money? It depends on how much the child is paid, and how much other income the child has for the year. Current tax law allows the dependent child to earn up to at least \$4,400 without paying tax. Thus, for this scenario, the child will not have to pay any federal taxes on the money. For other situations, the child's tax bracket would probably still be significantly lower than the sole proprietor, so there would still be sizeable potential tax savings.

Will this technique also work for a sole proprietor's spouse? The answer is no, for two reasons. First, the exception regarding not paying self employment taxes does not apply for a spouse. Second, the spouse's marginal tax bracket is normally the same as that of the sole proprietor since a joint tax return is usually filed, so there would be no tax savings here either.

Does that mean there is no tax saving benefit to employing a spouse in a sole proprietorship? Not necessarily. There may be some ways to save taxes using other possible angles. Here are some possible tax savings scenarios if a spouse is hired:

**Possible 6.2% tax savings on social security taxes:** If the spouse of a sole proprietor is already paying the maximum in social security tax from other earnings, and the sole proprietor is not paying the maximum, then a possible tax savings exists here. The sole proprietor would be able to deduct the spouse's wages, and save the self-employment tax on the deduction amount. Since the spouse has already "maxed out" on paying social security from another source of earnings, no extra social security tax would be due. Hence, a possible 6.2% tax savings.

**Possible 100% medical insurance/reimbursement plan write-offs:** Sole proprietors are normally not allowed to write-off 100% of their health insurance like certain "C-type" corporations are; they are also not allowed to set up a medical reimbursement plan for themselves to write-off the medical expenses that their insurance company won't cover.

However, if the sole proprietor hires his/her spouse properly, both of these write-offs could be achieved. Under federal rules for employee benefit programs, a spouse does qualify under health insurance coverage and deductions for said coverage. Thus, the sole proprietor could hire the spouse, cover the spouse under a "family plan" health insurance policy (instead of having a sole proprietor coverage plan), and take a full deduction for it. In effect, the sole proprietor has now covered everyone in the family, and gets a full tax write-off for the cost of the insurance.

**Increasing your deductible retirement plan contributions:** Employing a spouse can result in extra retirement plan deductions which results in extra tax savings. Under certain conditions, the spouse could be eligible to participate in various pension plans, such as IRAs in which more money could be put away than before. If the sole proprietor is already putting away the maximum \$2000 into a "working spouse" IRA, there is a possible scenario where the hired spouse could set up his/her own "working spouse" IRA, resulting in an additional \$2000 IRA deduction yearly.

While much too complicated to go into here, the same kind of techniques may be possible for other types of retirement plans, especially customized types a sole proprietor may use in the business.



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**Creating a deductible office in home write-off:** This is viewed by the IRS as a bit aggressive, but it survives challenge if done properly. The sole proprietor hires the spouse to do all the recordkeeping for the business. The spouse then uses a portion of the residence to perform these duties on an "exclusive and regular" basis. This could then qualify for office in home deductions where it previously didn't qualify under the current 2000 IRS rules for deducting a home office. The tax savings here would revolve around deductions for writing off a portion of the utilities, maintenance, and depreciation of the residence, or a portion of the rent being paid. This could save a considerable amount of taxes.

Similarly, under federal employee guidelines, a spouse as an employee can be covered under a medical reimbursement plan. This allows the employer—in this case the sole proprietor—to pay for (and deduct) the medical costs that the health insurance won't pay for. So if the health insurance had a high deductible, or if there were medical or dental expenses not being covered under the plan, a properly set-up medical reimbursement plan could result in large tax write-off for a sole proprietor. Like all "fringe benefit" planning, a number of other issues have to be considered, such as other employees, reporting requirements, and tax brackets, but the use of a hired spouse does create interesting tax write-off possibilities in this area.

There are other fringe benefit plans that could be set up for a spouse/employee to generate significant tax deductions and tax free or tax favored benefits, including such things as life insurance, pre-tax savings plans, and the use of a vehicle, to name a few.

### **Corporation**

There are both similarities and differences in employing family members in a corporate structure compared to a sole proprietorship. A corporation cannot exclude children under 18 from social security/medicare taxes. Consequently, there would be no savings on social security/medicare tax like there would be with a sole proprietorship.

However, the other options generally exist. Children could still be paid up to \$4,400 without any federal income tax liability, so this could save the corporation and owner/employees. The child's tax bracket would probably be lower, so money paid in this way could save significant corporate taxes. A spouse could also be hired to take advantage of various fringe benefits and retirement plans (providing the highly compensated tests are met), and might qualify for the home office write-off as well.

Another benefit to hiring family members is to avoid IRS challenge on excess compensation or accumulated earnings issues. Believe it or not, a corporation is not supposed to retain its earnings over certain acceptable levels or it could be hit with an IRS accumulated earnings tax penalty. In effect, the IRS wants the corporation to distribute these earnings in the form of dividends instead of retaining them. This is not a tremendous tax saving option. The corporation cannot deduct dividend distributions, but the recipients must pay tax on them. It is a form of double taxation, since the corporation already paid income tax on the original earnings.

Now, if a corporation facing this problem of excess accumulated earnings can justify hiring family members, it is a way of getting the money out in other than dividend distributions—a sizeable tax savings and a way of avoiding the double taxation issue.



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Similarly, certain corporations can be penalized for paying out excess compensation to the owner/employee. The IRS can take the position it is excessive and/or a form of a disguised dividend. Thus, putting family members on the payroll may help to defend this type of IRS challenge.

## **Conclusion**

Hiring family members can result in dramatic tax savings for a business. First, the deduction itself may save certain types of taxes, especially for sole proprietors. Second, if there is a significant tax-bracket differential between the family member and the business or business owner, this can also be used as an important tax-saving device.

Family members can benefit from various tax favored fringe benefits which the business can deduct. On the corporate level, they can be employed to alleviate certain IRS threats regarding excessive compensation or earnings, and save on taxes as well. All in all, there can be a number of attractive options in this area.