

Rules for Hiring Family Members

Many self-employed people want to hire family members to work for them. But as with many things in life, there's a right way and a wrong to do this. Doing it right can promote family togetherness. But it can also create tax savings for you.

How so? In essence, you are shifting business income to a relative. And your business can take a deduction for reasonable compensation paid to an employee, which in turn reduces the amount of taxable business income that flows through to you according to the AICPA's financial literacy Web site, www.360financialliteracy.org.

Of course, you have to do it right. The IRS can, for instance, question compensation paid to a family member if the amount doesn't seem reasonable, considering the services actually performed. Also, the AICPA says to be sure that your business complies with child labor laws when hiring a family member who's a minor.

There are other benefits to hiring a family member. As a business owner, you are responsible for paying Federal Income Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes on wages paid to your employees. FICA is the law requiring employers and employees to pay Social Security and Medicare taxes. FUTA is the law that establishes federal unemployment taxes.

As with wages paid to all employees, wages paid to family members are subject to withholding of certain taxes in some states. Typically, the payment of these taxes will be a deductible business expense for tax purposes. But if you hire family member – a child, spouse, or parent as an employee – to work for your business you may not have to pay FICA and FUTA taxes.

For instance, you don't have to pay FUTA taxes for services performed by your child who is under 21 years old. And you need not pay FICA taxes for your child who is under 18 and works in your trade or business or a partnership owned solely by you and your spouse, according to *Working for Yourself* (Nolo Press, \$39.99). For family members under age 18, the parent does not have to withhold for FICA, Medicare, FUTA and SUTA. If the spouse is employed, one does not have to withhold for FUTA and SUTA, but must withhold for FICA and Medicare.

For example, Jacob, age 15, proofreads press releases for his mother's public relations business, which is operated as a sole proprietorship. Jacob is his mother's employee, but she doesn't have to pay FUTA taxes until Jacob turns 21 and need not pay FICA taxes until he reaches 18.

Of note, these rules don't apply if you hire your child to work for your corporation or your partnership, unless all the partners are parents of the child. In other words, you must pay both FICA and FUTA taxes in the aforementioned cases. For example, Jack works in a landscaping business that is half owned by his father and half owned by his father's brother. FICA and FUTA taxes will have to be paid because it's a partnership and not all the partners are Jack's parents.

Also of note, if your child has no unearned income (dividend income or interest) then you must withhold income taxes from your child's pay only if it exceeds the standard deduction for the year. The standard deduction for 2004 was \$4,850, but it's adjusted every year for inflation. Children who are paid less than this amount need not pay any income taxes on their earnings. You must, however, withhold incomes taxes if your child has more than \$250 in unearned income for the year and his or her total income exceeds \$750. If you pay your child more than \$600 or more during the year, you must file a Form W-2 reporting the earnings to the IRS. Regardless of how much you pay your child, each year you should fill out and have your child sign IRS Form W-4, Employee's Withholding Allowance Certificate. If you pay your child more than \$200 per week, keep a copy of the form for your records and file a copy of the form with the IRS.

For small business owners who are engaged in what is often called succession planning, hiring children can provide non-tax benefits as well. Children who play a role in a business can help it survive past the owner's involvement. "Family Affair: The Emotional Issues of Succession Planning," which can be found in the *Journal of Financial Planning's* July 2005 issue, is one story worth reading on the subject.

Meanwhile, if you employ your spouse to work in your trade or business, the payments are subject to FICA taxes and federal income tax withholding, but not FUTA taxes. This rule doesn't apply if your spouse works for a corporation, even if you control it, or a partnership, even if your spouse is a partner along with you. In that case, you will have to pay FUTA taxes.

If you employ a parent in your trade or profession, meanwhile, his or her wages are subject to income tax withholding and the FICA taxes, but not FUTA taxes.