

# *Sy Accountancy Corporation*

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

## PUTTING FAMILY MEMBERS ON PAYROLL

By Victor Sy, CPA, MBA

If you own a business and have kids in high school and college levels, this article might be of interest to you. Read on and learn about benefits of income splitting, Social Security (SS) coverage, travel, payroll tax savings, and retirement plan. We will discuss each of these benefits in the following paragraphs:

1. **Income Shifting:** Income taxes can be saved by shifting income from a high tax bracket to a lower tax bracket individual. You can avail of this income splitting by employing your children. If you operate a business as a sole proprietor and have a teenager employed at about \$9,500 for the year, you could save anywhere from \$1,500 to \$3,500 in Federal and State taxes depending on your tax bracket.

Note that even the IRS has sanctioned paying children in a tax court decision when the owner's children, the youngest of who was only seven at that time, was allowed salaries for services actually rendered. We do not want you to start employing your first graders. We do want you to know that this concept works for kids who actually work.

For you to benefit from this tax-planning tip, the employment must be bonafide. You should be prepared to show duties performed and hours spent on the job. As usual, good record keeping such as timesheets, timeclock or a diary of the work performed is essential since payments to relatives are suspect in the eyes of the IRS. The work must generate ordinary and necessary expense or be helpful and appropriate. It could be work that would otherwise be performed by you as parents so that employing your child would give you more time to engage in more profitable activities. Your child's work must be helpful and appropriate for the business such as filing, computer keypunching, janitorial, clerical. It does make economic sense because if your children do not do such tasks, you would have to employ outsiders anyway. The beauty of this arrangement is that instead of paying non-deductible tuition fees out of your after-tax dollars, you end up deducting their tuition fees indirectly by paying them salaries

2. **Retirement Savings:** Because your children and spouse have earnings, they may contribute to their separate IRAs for income tax purposes. If you contribute \$5,000 toward an IRA for your child, you could increase the child's pay to about \$14,500 and save as much as \$2,500 to \$5,000. While you are on streak, you might as well consider employing your other children. This makes sense because you would shift income from a top tax rate bracket of 35% for Federal and 9.3% for State down to the kids' planned income tax rate of zero for both Federal and State.
3. **Payroll Tax Savings:** If you operate your business as a sole proprietor, you may have additional savings because you are not required to pay or withhold FICA or FUTA on wages paid to your children under the age of 18 and 21, respectively. There is an irony that works for you: Your children under age 18 are not considered employees for payroll tax purposes but are considered employees for income tax purposes. You end up with a double whammy: You do not pay FICA and FUTA taxes yet deduct their salaries as expenses. Nice.
4. **Medical Reimbursement Plans:** You may cover your spouse and dependents under a medical reimbursement plan and deduct such cost. Be careful not to discriminate against employees who are outside the family for the plan to survive an IRS examination.

5. **Social Security Coverage:** No Federal tax savings is realized by putting your spouse on payroll. However, you indirectly save through retirement plan opportunities and medical reimbursement plans as discussed above with a seldom-used benefit: Social Security benefits for your spouse. All your spouse needs to earn is \$4,480 for 2011 (\$4,520 for 2012) to be given credit this whole year for Social Security.
6. **Travel Expenses:** Caveat: airline tickets, lodging and meals for bonafide business purposes for your spouse and family members are denied unless they are employees of your business. (It will be quite interesting to see a sudden surge in the employment of spouses and kids as a result of this new rule that restricts travel deductions).

As you can see, there are benefits, lots of it, in employing family members. Do not ignore this planning technique the next time you see your accountant.