<u>Daddy's Little Tax Deduction</u>

By John Hyre, Tax Attorney, Tax Accountant Real Estate Investor

Keeping your tax bill low is a war of details. There is no magical silver bullet that holds the IRS at bay. Rather, the tax code lets us cut a little here and a little there. It's all in the details. Such "details" include your children. There are lots of ways to use the little darlings (I use the term loosely and obviously am not referring to teenagers!) to cut your tax bill. This article will focus on how to hire minor children in your business.

Specifically: If you have children between the ages of 7 and 17 and have not hired them in your business, the government is getting far too much of your money. And you are cheating your children of a remarkable character-building opportunity. On the other hand, hiring the kids saves you money and provides them with some hands on education. Here's how it works:

Let's say you are in a 30% tax bracket. Your business makes $75,000 in net income. You want to spend $4,750 on one of the kids. If you take that amount out of the business and spend it, you will pay $1,425 in taxes, leaving $3,325 to spend.

Instead, you hire your child. Each child has a $4,750 standard deduction – meaning that they do not pay federal income taxes on the first $4,750 in income. So you pay the child $4,750. Your business deducts that amount. The child uses the standard deduction to shelter the income. Result: You save $1,425 in taxes. Common questions:

<u>Do we pay social security taxes on that wage?</u>

No, if your child is under 18 years old AND you pay them out of a sole proprietorship, partnership or most LLC's. If you pay them out of a corporation or an LLC treated as a corporation, then they owe social security taxes.

<u>Is there lots of paperwork?</u>:

You have to file a Form 941 four times per year. That's the form that the IRS uses to get employers to withhold income and social insecurity taxes. For a child, it's easy – there will be no withholding, so enter lots of zeroes on the form.

You need to issue a W-2 after year end. Easy enough.

You need to track the child's hours and activities to prove that they did the work and that the type of work was within their capacity. A consistently kept Excel spreadsheet or "dead tree" notebook will do nicely. Bear in mind that the Tax Court has permitted parents to employ children as young as 7 years old as long as the work and pay were reasonable. 7-year olds can certainly pick up debris, lick envelopes, place stamps and the like. Obviously, the older the child, the more they can do. The pay should be a bit less than you'd pay a third party.

Do the children get to do whatever they want with the money?

Heck no! The money goes into a bank account and gets spent on what you say, when you say. Clothes, tuition and toys are all valid options. Using it to fund Roth IRA's or (better yet) Roth Educational Accounts (also known as "Coverdales") is a very tax savvy way to go.

Any tax traps involved?

Yes. Make sure that the children do not account for more than 49% of their upkeep. If they pay for 50% or more of their total expenses, you lose them as an itemized deduction on your personal return (Meaning you'd lose @ $3,000 in deductions AND the $1,000 child tax credit – ouch!). Using a program like Quicken or Microsoft Money can help you track kids' total expenses (including housing and food) to make sure that you do not cross the 50% line.

Also, this particular tax tactic involves paying the kids for services. Providing passive income (like rents and interest) to children under 14 normally results in negative tax consequences. Now there are ways to give kids over 13 passive types of income while cutting taxes in a serious way – but that's a story for another article.

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