Employing Your Children:
Understanding the Tax Implications and Benefits

Hiring your children in your family business can be a good way to build life skills, instill responsibility, and teach the value of work and for optimizing your family's tax situation. However, it's crucial to navigate the tax landscape with caution to fully leverage the benefits while staying within the confines of the law so that you are not bumping into unintended consequences. Let's delve into the key tax considerations.

Understanding the Kiddie Tax

The Kiddie Tax is designed to prevent high-income parents from shifting their investment income to their children who would be taxed at a lower rate. This tax applies to a child's unearned income over $1,250 in 2023, such as interest, dividends, or capital gains. It's important to note that the Kiddie Tax won't apply to earned income from work done by the child, which could create a potential avenue for tax savings. This could potentially come up if you were to compensate your children by helping them set up any taxable investment accounts.

Payroll Taxes and Business Structures

If your child is under 18, the wages you pay them are exempt from Social Security and Medicare taxes if your business is a sole proprietorship or a partnership where both partners are the child's parents. However, if your business is a corporation or a partnership that includes non-parent partners, payroll taxes are applicable. Also keep in mind that 14 is the minimum age at which you can legally employ your children, according to the Fair Labor Standards Act (FLSA).

In this scenario, if your child makes over the standard deduction ($13,850 in 2023), they may need to file their own tax return. However, they will be taxed at their own tax rates, not yours, typically resulting in less tax due. Further, if you contribute to a custodial IRA on their behalf, their earnings could grow tax-deferred, compounding their wealth accumulation over time.

Gift Tax and Family Limited Partnerships

The annual gift tax exclusion for 2023 is $17,000 per recipient. This means you can give up to $17,000 worth of assets to each child without incurring the gift tax.

One strategy to consider is a Family Limited Partnership (FLP). An FLP allows you to transfer assets, including interests in a family business, to your children while retaining control over these assets. But be mindful that gifting shares of your business to your child could trigger gift tax if the value of the shares exceeds the annual gift tax exclusion.

Employment Documentation and Reasonable Compensation

When it comes to the mechanics of hiring your children, it's crucial to document their employment properly. This includes maintaining proper payroll records, having a written job description, and ensuring their wages are reasonable for the work performed. These steps not only legitimize your child's employment but also protect you in case of an IRS audit. That means you can not pay your children a million dollars for taking out the trash.

Impact on Financial Aid

Consider that your child's earned income can impact their eligibility for need-based college financial aid. While this doesn't pose a tax issue, it's an important financial consideration that requires strategic planning. One tip is that money invested in a custodial Roth IRA for your child is not counted as an asset for financial aid purposes.

Long-term Legacy Planning

Employing your children isn't just about immediate tax benefits. It's also about long-term growth and legacy planning. It's an opportunity to nurture their financial acumen, entrepreneurial spirit, and to continue the family tradition. It may be one of the best gifts you can give your children – the gift of practical knowledge and a secure financial future.

While this strategy offers promising benefits, it's not without its complexities. Navigating the tax laws surrounding employing family members can be tricky and getting it wrong can be costly. For this reason, it's advisable to work with a financial advisor to ensure you're staying within the legal boundaries and optimizing your family's tax situation. Consider speaking with an advisor at My Financial Coach for tailored advice that fits your unique situation.

Please remember, every family's tax situation is unique, so it's important to consult with your financial advisor or tax professional before making any decisions.