Pay Children and Save on Taxes

By Robert Anderson

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Tax-filing season is a busy time at my office, and there is very little time for idle conversation at tax appointments. However, I always try to set aside some time at each appointment to do some tax planning for the coming year, because I think tax planning is most effective when it is considered year round, rather than just in December.

One of the planning tools I stress is paying wages to children that are living at home. On every farm, there are always chores that all but the smallest members of the family can do. Paying wages to the children for those jobs can offer some real tax savings for the family, and allow the children to build a nest egg that can help them pay for college or start a career or a family.

Shift tax burden to the children

For those farmers operating their farms as a sole proprietorship, paying wages to the children has two tax advantages. First, there is no social security withheld on wages paid to dependant children under 18. Second, wages will be tax free for single dependant children whose earned income is $5000 or less. Meanwhile, the wages are deductible on the parent's Schedule F.

For example, I have a family with two children who do livestock chores throughout the year, as well as field work in the summer. The youngest is being paid $2000 per year; the older child is being paid $4000 per year. Neither child is paying any tax on those earnings. However, the parents are saving federal income taxes, self-employment taxes, and Minnesota state taxes on those wages. Their total tax savings last year on the $6000 of wages they paid the kids was $2077. In this example, the parents were in the 15% federal tax bracket; their tax savings would, of course, have been larger if they had been in a higher tax bracket.

If the farm is incorporated, the corporation can still pay wages to the owner's children, however, the corporation will be responsible to withhold FICA on the children's wages, even if they are under 18. However, the income tax advantages will still be available.

Invest the child's wages

The next question is what to do with the earnings. In our example, the parents are investing the children's wages in Roth IRAs. For 2005, the maximum Roth IRA contribution is the contributor's earned income or $4000, whichever is less. In the example above, the younger child can contribute his whole $2000 wage and the older child his whole $4000 wage. The parents chose this investment vehicle for several reasons. First, the earnings will grow tax free, and will be tax free if withdrawn at retirement age. Second, the contributed amount can be withdrawn at any time, and can be used by the child for college expenses. Third, Roth IRAs, like other retirement plans, are not included as assets on the FAFSA (Free Application for Federal Student Aid) form, and thus do not affect the child's financial aid eligibility.

Follow proper procedures

There are a several other things to consider before adopting this strategy. First, the wage rate needs to be reasonable and wages need to be based on actual hours worked. Second, proper procedures need to be followed, that is, W-2s need to be provided to the children, and tax returns filed for them if necessary. Finally, farm work needs to be performed by the children to be deductible on Schedule F. If wages are being paid for housework, the children can still be issued a paycheck and qualify for an IRA contribution, but the wages cannot be deducted by the parents.