

Price & Farrington's Estate and Tax Planning FastFacts

December, 2003

Estate, Tax and Wealth Planning for Advisors and Clients

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Majoring in Minors: Business Owners' Kids Can Help and Provide Tax Breaks



Can your clients' young children work in the family business? A tax-savvy way of taking care of kids' allowances or spending money is for their parents to pay them wages for work they do for the business, regardless of whether it is a full time, established business or a new, part-time sideline.

This isn't just a tax-saving strategy for the family. It provides children with jobs that put some "jingle in their jeans", exposes them to the business and instills a work ethic. You just need to make sure you watch the rules carefully.

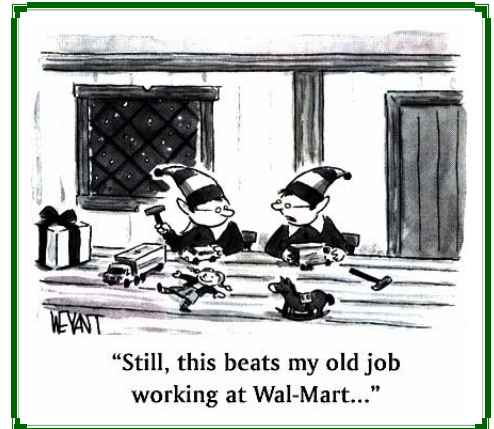
Beat the kiddie tax. Putting children on the payroll is a perfectly legal way to keep income in the family while shifting it into the children's lower tax bracket. This strategy isn't crimped by "kiddie tax" rules that limit parents' ability to shelter investment income by making gifts to their children of cash, stocks and other income-generating assets. Under those rules, interest, dividends, capital gains and other kinds of investment income received by a child under age 14 are governed by restrictive rules when the income exceeds a certain amount, triggering tax at the parents' top rate.

Kiddie tax restrictions don't apply to children's wages, whether earned from babysitting, delivering newspapers, or

working for a family-owned business. The business gets to deduct the wages, which are taxed to the child at the child's own rate. It might actually be better to pay wages to an under-14 child than to give assets that generate an identical amount in income. As with investment income, the child gets to offset earned income with a standard deduction, but one that is more than six times greater. *Contrast:* the flat amount standard deduction for 2003 is capped at \$750 for investment income but tops out at \$4750 for wages and other earned income. The result? The more income the child receives as earnings, the more that escapes taxes because of the higher standard deduction (which also is indexed).

An Example. This arrangement works nicely regardless of the child's age: Client hires his seventeen year old daughter, Samantha, to do clerical work for him after school, on weekends, and during her school vacations. She earns \$4750 in 2003 and sidesteps taxes on her entire wages since they are sheltered by a standard deduction of \$4750. Earnings above \$4750 will result in a tax liability for her but the excess falls into the bottom income tax bracket of 10%, which applies to taxable income of up to \$7000. In 2003, Samantha would have to earn more than \$28,400 to reach the relatively lofty 25% bracket. (Assuming your client falls into a 35% tax bracket, hiring his daughter lowers his taxes by more than \$1660 – 35% of \$4750. The exact amount will depend on whether Samantha's wages are subject to Social Security and other payroll taxes.)

There are also other breaks. Generally, the wages paid to Samantha and other employees are subject to Social Security (6.2%) and Medicare (1.45%) taxes. These aggregate to 15.3% (7.65% each for both employer and



"Still, this beats my old job working at Wal-Mart..."

employee). But the Internal Revenue Code authorizes an exemption from those taxes for wages paid to under-age-18 sons or daughters. The exemption applies to your clients if they are doing business as a sole proprietorship or a husband-and-wife partnership. Whatever income they can shift to their kids lowers their Social Security taxes by as much as 15.3%. (In 2003, this rate applies just to the first \$87,000 of net self-employment earnings; beyond that figure, the rate drops to 2.9%.)

Roth. Each year Samantha can also put part of her wages into a Roth IRA – as much as \$3000 in 2003. To be eligible, she must have earned income, but *the source of that \$3000 need not be her wages.* It can be a gift from her parents or grandparents. She gets no deductions for her Roth contributions, but the write-offs would be tiny anyway because her bracket is low – 10%, 15% or even zero. The big benefit is that those Roth contributions will grow tax-free. Samantha can withdraw contributions at any time if she needs to tap the account. Generally, she won't be able to withdraw earnings free of taxes until she turns 59 1/2, by which time they will have swelled enormously.

In the meantime, Samantha remains an exemption on her parents' income tax



Happy Holidays from all of us at
Price & Farrington, PLLC.

Our best wishes to you, your family and your loved ones for a festive holiday season and a healthy, prosperous 2004!

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Child Labor

If you are thinking about advising your self-employed clients to hire their kids, here are some jobs that make business sense and can pass muster with the IRS:

- ☛ Answering telephone calls
- ☛ Cleaning offices
- ☛ Addressing envelopes
- ☛ Filing
- ☛ Bookkeeping
- ☛ Performing secretarial and other clerical work
- ☛ Making deliveries
- ☛ Creating websites and other computer work

return, provided they meet certain requirements. For the year in question, they have to furnish more than half of her total support – food, shelter, clothing, medical care, health insurance costs, education, recreation and similar necessities. Samantha must be under age 19 at the end of the year or under age 24 if she is a full-time student who spends at least five months in school.

Caution: IRS auditors are suspicious of deductions for wages paid to children. The write-offs survive scrutiny only if your clients can establish that the children actually render services. The Feds are likely to throw out a deduction for a six-year-old doing photocopies since someone that age likely lacks the skills or discipline for office work.

Another hurdle is the “reasonableness”

requirement. Wages paid to children cannot be more than the going rate for unrelated employees who perform comparable tasks. Parents should treat their children the same as any other employee and keep the usual records showing amounts paid and hours worked. They must issue W-2 forms, even if their children are exempt from withholding. They should also use checks drawn on the business account to make payments.

Falling Afoul. There are a number of ways to fall afoul of the IRS. Some real life examples:

Case 1: Surveying dad’s checking account. The Tax Court threw out deductions over a two year period for payments made by an Indiana surveyor to his children, ages 9 and 11, for sweeping out his office and helping him with surveys. He kept no records of the time they worked. And his case really went down the drain when the judge examined the children’s pay checks and found that they had been redepicted in their father’s account!

Case 2: Doctoring the return. The Tax Court concluded that the “salary” a physician had paid to his teenage daughter was merely an allowance and not, as he claimed, wages paid for secretarial services at his office and for regularly answering calls from patients at his home when his answering service was off and he didn’t want to be disturbed. A skeptical judge noted that children (especially teenagers) normally answer the family phone. The doctor’s case wasn’t helped by his admission that he made the entire payment to his daughter in advance, while paying nothing to his son for answering calls. The clincher was his failure to keep records showing when she worked for him at his office or home and his failure to withhold taxes.

Case 3: Mobilizing the kids. Mom and Dad hired their three children, ages 7, 11 and 12, to work at their mobile home parks. During a three year period the kids cleaned the grounds and laundry room, performed landscaping work maintained the swimming pool, read gas meters, answered phones, delivered leaflets and messages, and made minor repairs. They deducted nearly \$18,000 of their payments to the children as “outside services”. The IRS disallowed about 90% as unreasonable.

The Tax Court, however, concluded that had the children not done the work, the parents would have had to hire some-

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one else to do it. Because their children performed “substantial services”, the court approved more than \$15,000 as allowable deductions. Most of the disallowance was attributable to the 7- year old, although around \$4,000 of his earnings were approved. “Experience teaches that 11- and 12- year old children can generally handle greater responsibility and perform greater services than 7- year old children,” the judge explained.

Bottom line: reasonableness. Child-employee deductions can provide small business owners with considerable tax breaks. To pass muster with the IRS, though, parent-owners must truly treat their children like employees. This means documenting the chores they perform, ensuring that their work is necessary for business, and paying them a reasonable amount for the work performed. ■



This month’s tax-sensitive topic reminds us that the C.P.A. is a vital member of a client’s estate planning team. We always work closely with our clients’ C.P.A.s in advising on tax, estate planning and wealth transfer strategies. As always, please let us know how we may be of assistance to you.



Glen D. Price

Seasonal Offerings:

“Why does Christmas always come just when the stores are so crowded?”

“Oh, honey, you gave me just what I needed to exchange for what I wanted...”

“Sign in a big store:
Five Santas, no waiting!”

“We got the kids something nice for Christmas—their own apartment.”

“He’s a man of rare gifts. Hasn’t given one in years.”