Tax Benefits of Employing Family Members

As the owner of a closely held business, you have the power to control the flow of income to your family members by placing them on the payroll. Handled properly, your business will receive a tax deduction for compensation paid and the family member will receive taxable income, possibly taxed at a lower rate, and, in some cases, other economic benefits with little or no cost. Below is a listing of the various ways tax savings and other benefits can be achieved by hiring a family member.

Income Tax Benefits

If you employ a family member, you can take a deduction for compensation paid to the family member just as with an unrelated employee. However, you cannot take a legitimate tax deduction if the family member does not actually perform services for the company, or if the services rendered bear no reasonable relationship to the compensation paid. If the compensation paid is to be deductible in full, it must be reasonable. To qualify as reasonable, the compensation paid the family member must be in accord with the prevailing rate of compensation for comparable positions with comparable employers.

If the family member you employ is your dependent child, additional tax savings can be achieved, as their income will generally be taxed at a much lower rate. Depending on the amount of income paid to the child, the entire amount may be able to be sheltered through the use of the standard deduction and by making a tax-deductible contribution to an IRA. For 2005 the maximum amount that may be sheltered under this approach is $9,150.

Employment Tax Benefits

If you employ your child and that child is under the age of 18, these wages are not subject to social security taxes. A similar exemption applies to FUTA taxes with any earnings paid to your child under the age of 21 exempted from FUTA taxes.

Pension Plan Benefits

Under the Internal Revenue Code, you are permitted to pay a minimum pension of $10,000 a year even though that is in excess of a participant's average compensation for his or her three best years. Under this provision, it would be possible to provide a pension for your spouse in the amount of $10,000 a year at age 65, even though your spouse became an employee at age 55 and never earned more than $5,000 a year in salary. Your business would be required to make substantial contributions to the plan in order to accumulate sufficient funds to provide the $10,000 pension for life. These payments would be deductible, provided that the aggregate amount of compensation paid, salary, pension contribution, and other compensation was not unreasonable. Note, however, that the $10,000 minimum pension is reduced by 10 percent for each year that your spouse has worked for less than 10 years. If your business cannot make the large contributions required, lesser benefits may be made available under defined benefit or defined contribution plans.

IRA Benefits

An employed family member can contribute up to 100 percent of the compensation paid to him or her (but not in excess of $4,000 in 2006) to an IRA. However, the contributions will not be deductible if your business has a qualified plan in which the family member participates and the family member has income above a certain level.

Alternatively, an employed family member participating in a SIMPLE IRA set up by you (only if you have 100 or fewer employees) may make elective contributions (as part of a salary reduction arrangement) of up to $10,000 in 2006 to the SIMPLE IRA. To participate, the family member must receive at least $5,000 in compensation. Generally, if you set up a SIMPLE IRA, you may not set up other types of pension plans (however, if you maintain another type of qualified plan for your union employees you may set up a SIMPLE IRA for your nonunion employees). You must match the employee's contribution, up to a maximum of three percent of the employee's salary.

Insurance Benefits

By employing a spouse and providing employees with health benefits, including coverage for spouses, you can effectively achieve a deduction for coverage for yourself and your spouse. This would include any reimbursements made under the plan. Absent this approach, if you directly purchased coverage for yourself and your spouse and dependents, your deduction would be 100 percent of the cost thereof for 2004 and thereafter.

In addition to providing health insurance, you may be able to provide a family member employed by your business with group-term life insurance coverage and receive a deduction of up to $50,000 for the cost of the coverage. Furthermore, if the family member-employee wishes to purchase coverage with a cost in excess of $50,000, the premiums will generally be less than if the employee purchased a policy on his own. However, coverage premiums in excess of $50,000 paid by the employer results in a taxable benefit to the employee.

Child and Dependent Care Credit

If your spouse works for the business without pay and has incurred dependent care expenses, you can achieve a tax benefit by putting that unpaid spouse on the payroll. Doing so may enable you to claim a tax credit for dependent care expenses.

The maximum amount of eligible expenses for taxpayers maintaining a household for one qualifying individual is $3,000 (for two or more qualifying individuals the maximum is $6,000). (A qualifying individual is a dependent of the taxpayer under age 13 or a dependent that is incapable of caring for himself or herself.) The amount of the credit is equal to the applicable percentage of the employment-related child and dependent care expenses you paid during the year. The maximum amount of expenses eligible for the credit must be reduced by the amount excludable under an employer-provided dependent care assistance plan.

For 2004 and subsequent years, the maximum percentage of employment-related expenses is 35 percent and the income threshold for reduction of the credit is $15,000. The credit is reduced by one percentage point for each $2,000 of adjusted gross income or fraction thereof, above $15,000. If your adjusted gross income is over $43,000, you are allowed a credit equal to 20 percent of your employment-related expenses, provided you file a joint return.

The purpose of the expense must be to enable your spouse to be gainfully employed. The credit may be denied if the salary is only nominal. In addition, the expenses that qualify for the credit are those that are incurred primarily to assure your child's well being and protection. Thus, the costs of food, clothing, entertainment and education are not considered expenses paid for such care. But, if those expenses include other benefits that are incident to, and inseparably a part of the care, the full amount paid is considered to be incurred for care. For example, payments to a nursery school for an enrolled qualifying child are considered as being entirely for care even though the school also furnishes lunches and educational services. Educational expenses incurred for a child in the first grade or above are not expenses incurred for the care of a qualifying individual.

Family Members on Board of Directors

If your business is conducted in corporate form, consideration might be given to having relatives with some business experience serve on your board of directors. Their compensation as directors would be considered self-employment income and could form the basis for a contribution to a Keogh plan and an IRA. Corporate directors' fees are treated as received when services are performed, regardless of when they are actually paid, for purposes of both the self-employment tax and the earnings test for loss of social security benefits. Directors whose income is already in excess of the social security wage base due to earnings from other sources in the year the deferred fees are earned will not have to pay self- employment taxes when the deferred fees are paid.