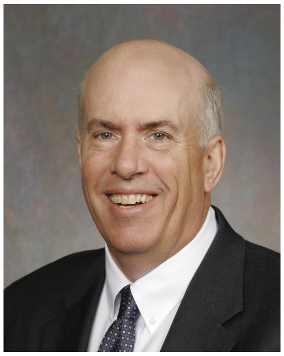

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Putting Child on Company Payroll

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What is it?

If you own a business and your child has education expenses, you may be able to shift income into a lower tax bracket by putting your child on your company's payroll. Presumably, your child is in a lower tax bracket than you. If so, then your child's earned income will be taxed at a lower rate than yours. Your child can work in the family business, receive a weekly paycheck, and accumulate money for private secondary school, college, or graduate school. In the end, your child will be using wages that have been taxed at as little as 10 percent. If, instead you use your income to pay for your child's education expenses, then you will be using wages that have been taxed as high as 35 percent. That means that more of the family income will go to paying incomes taxes and less will go to education costs.

Example(s): *Jill needs money for college. Sue, her mother, owns a closely held business and is in the top tax bracket. Sue increases her own salary by $10,000 to raise money for Jill. Over the next year, Sue draws an additional $10,000 in salary that is taxed at the top rate of 35 percent. At the end of the year, Sue has paid $3,500 (assume no other variables) in federal taxes on her additional income and has $6,500 to give to Jill.*

Example(s): *Fred also needs money for college. Mary, his mother, owns a closely held business and is in the top tax bracket. Mary puts Fred to work in the family business. Like other employees, he receives a weekly paycheck. He works 20 hours per week at $10 per hour. He earns $200 per week. At the end of 50 weeks, Fred has earned $10,000. Assume Fred's standard deduction is $5,150, and everything over that amount is taxed at a rate of 10 percent. Fred pays $485 (assume no other variables) in federal taxes. He is left with $9,515 for college expenses, $3,015 more than Jill for the same $10,000 of income.*

How does it work?

Hire your child as an employee in the family business. It is not enough that you merely put your child on the payroll; she must actually work for her wages. Issue her a paycheck, just as you do with other employees. Make an agreement with your child that all, or some portion, of what she earns will be applied to education costs.

When can it be used?

When you are in a higher tax bracket than your child's

This planning option provides a tax savings to the family only if your child is in a lower tax bracket than you. Generally, this is a given, but if your child realizes significant income from trust funds or other sources, then there may be limited tax savings available.

Your child can be employed

As mentioned, it is not enough that you put your child on the payroll. He or she must work to earn his or her wages. You should check the child labor laws in your state to determine at what age, and for how many hours, he or she may legally work.

Caution: *If you pay your child more than a reasonable amount of compensation for his or her services, the IRS may deem the excess a gift.*

Strengths

The kiddie tax does not apply

The kiddie tax applies only to unearned income. If your child is earning his or her wages, the kiddie tax does not present a planning issue.

Gift tax does not apply

Gift tax does not apply if your child earns his or her income.

Caution: *As explained above, if you pay your child an unreasonable amount of compensation for the work performed, the payments could be deemed a gift to the extent that they exceed a reasonable amount.*

No Social Security tax is due if your child is under 18 and employed by you

Not only can your child earn income in a lower tax bracket than yours, he or she can do so without paying Social Security tax. This allows him or her to use even more of her gross income for education expenses. As an additional bonus, her employer (you) does not have to pay the required employer contribution to Social Security. Accordingly, the business also benefits.

Your child obtains practical work experience

By working in the family business, your child may gain practical work experience. This is probably valuable in and of itself. However, it also provides substance for your child's first resume and may teach your child some transferable skills.

Tradeoffs

Accumulated wages form an asset that can reduce your child's financial aid award for college

As discussed above, if your child is seeking financial aid, this strategy could reduce his or her award. These planning strategies may provide limited benefits if your child qualifies, or is likely to qualify, for financial aid. The majority of college financial aid is based on need. The federal government is the largest dispenser of need-based financial aid. Under the federal government's methodology for determining family need, the assets and income of both a child and her parents are considered when calculating the expected family contribution. A child's assets are weighted more heavily than those of the parents under the federal government's methodology for determining need. Accordingly, most experts recommend that your child hold no assets in his or her name as of the date that the financial aid application is completed.

The problem arises when a child has worked in the family business for several years, shifting family income to a lower tax bracket, only to find that he or she now has a large asset (accumulated wages stashed away in a savings account) that may reduce any financial aid award.

Tip: *To avoid this outcome, your child can put his accumulated earnings into an* IRA *. The IRA does not need to be listed as an asset for financial aid purposes and special rules apply to withdrawals from IRAs used for higher education expenses.*

Tip: *Another way to avoid this outcome is for your child to spend his or her earnings in the year before your child applies for financial aid. Your child can use his or her accumulated earnings to prepurchase college necessities. Once the money is spent, it is no longer an asset. Your child might purchase a computer, a car, or anything that he or she will inevitably need to get through college.*

Caution: *Seek the advice of an attorney and tax planner when structuring this kind of transfer. You want to ensure that it is not deemed a sham transaction by the IRS.*

High annual earnings may further reduce your child's financial aid award

Depending upon how much your child earns, and when it is earned, working in the family business can reduce his or her ability to take advantage of need-based financial aid.

Tip: *When calculating* financial aid *, the government examines how much money the child earned in the year immediately prior to the date of the financial aid application. To maximize a financial aid award, you may want to take your child off of the payroll for the year prior to the time that he or she plans to apply.*

Your child has to work for education expenses

This may not seem like a tradeoff for you, but it may seem like a tradeoff for your child. Using this strategy, your child will have to earn money for college expenses. If he or she is still in high school, a part-time job could infringe on time that could be put into homework, sports, extracurricular activities, and social events.

Caution: *Be certain that your child's work schedule does not impede his or her ability to keep grades up, complete college admissions applications, and file financial aid forms.*

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