STRATEGIES FOR HIRING CHILDREN FOR TAX DEDUCTIONS

By Randy Larson and Stephan McKee

Hiring children in a family business can provide valuable tax benefits for both the company and the child. The company can deduct the child's wages as a business expense, while the child benefits from earning income that can be invested in a Roth IRA for tax-free growth over many years. This can be complicated if not set up correctly and can attract attention from the IRS during an audit. To safeguard the company’s deductions and ensure compliance, it's essential to follow the following guidelines and maintain accurate documentation. Failure to adhere to these practices could lead to the IRS or state authorities questioning the legitimacy of the child’s employment and disallowing the associated deductions.

Legitimate Work

The child must perform genuine work relevant to the company’s operations. Record work hours, tasks performed, and ensure compliance with labor laws (e.g., restrictions on operating heavy machinery for minors).

Market Rate Compensation

The child’s wages should match what other employees performing similar tasks earn and should not exceed the pay rate for similar work in the local area.

Proper Documentation

The child should complete federal and state tax forms (W-4s, I-9 for employment eligibility), and the company should keep these forms and other employment documents in the child's personnel file.

Payroll Processing

All payments should be processed through the company’s payroll system, with appropriate taxes and benefits withheld.

Issue a W-2 to the child, as you would for other employees, though a 1099 may be appropriate depending on the arrangement.

Note: For sole proprietorships or partnerships with both parents as partners, wages for children under 18 are exempt from Social Security and Medicare taxes, and wages for children under 21 are exempt from FUTA tax. These exemptions do not apply to C Corporations, S Corporations, estates, or partnerships with non-parent owners. All wages are subject to income tax withholding, though this requirement may be minimal depending on the child’s total income. The Kiddie Tax, which applies to unearned income like dividends, does not affect wages earned from work. As of 2024, the Kiddie Tax applies to unearned income over $2,400.

Bank Deposits

Paychecks should be deposited into the child’s bank account. If the child chooses to invest all or part of their wages in a Roth IRA or other investment account, document these instructions.

Tax Returns

The child must file federal and state tax returns to report income and pay any applicable taxes. For 2024, the standard deduction for a single taxpayer is $14,600, which means if the child’s earned income is below this amount, they may not owe federal income tax, though they still need to file a return.

By adhering to these steps, both the company and the child can enjoy the tax advantages of employing a family member while ensuring compliance with relevant tax laws.

Beyond deducting taxes for yourself and keeping more money in your pocket, establishing a Roth IRA for your child meets the goal we all have for our children; ensuring their success and helping them succeed further than we have.

You can read more on financial planning basics for your children here:
https://25financial.com/financial-planning-basics-for-our-kids-and-community/