Business Planning

Do’s and don'ts for employing children in a family business.

By Eva Stark, JD, LL.M.

Parents typically want their children to learn the value of work while they are young to help them become productive members of society. Parents who own a small business and want to employ their children to help pass down family values, teach valuable skills and work ethic, and potentially save on taxes, should consider the following do's and do not's related to employing a child in a family business before adding Junior to the payroll.

DO learn about potential income tax advantages.

Employing a child in the family business may enable parents to shift income from the parents’ higher income tax bracket to the child’s lower income tax bracket—which can produce significant tax savings. The “shift” in income occurs because the payments for the child’s services generally constitute a business expense that is deducted from the parent’s business income (if the business is a pass-through entity) or the business’s income (if the business is not a pass-through entity). Such wages are then includible in the child’s income and taxed accordingly—ideally at a much lower rate. In some cases, the child’s income tax bracket may be as low as 0% if the child earns less than the standard deduction amount ($13,850 in 2023). The dreaded “kiddie tax,” which can mandate the taxation of a child’s unearned income at the parents’ higher income tax rate, generally does not apply because wages are earned income. State-level income tax benefits or drawbacks may also apply and their potential impact also should be considered.

DO explore potential employment tax advantages.

While the child’s wages are subject to income tax as mentioned above, they may be exempt from employment taxes in some cases. Social Security, Medicare, and Federal Unemployment Tax Act (FUTA) taxes may or may not be required depending on a combination of (i) the ownership structure of the business and (ii) the age of the child. If the business is a corporation, or a partnership with a partner who is not the child’s parent, then payments to the child are generally subject to Social Security, Medicare, and FUTA taxes regardless of the child’s age. However, if the business is a sole proprietorship or a partnership where each partner is a parent of the child, then Social Security and Medicare withholding is generally not required if the child is under age 18 and FUTA tax is generally not required if the child is under age 21. As in the income tax arena, state-level unemployment taxes vary and also should be considered.

DO ensure that the child does actual and reasonably necessary work.

A business owner cannot simply add his or her child to the payroll and thereby manufacture a tax deduction. The child must perform actual work for the business by providing some service that is reasonably necessary or helpful to the business. Paying wages to the child for taking out the trash at home or watching cartoons on business premises is unlikely to withstand scrutiny. The child must also be capable of performing the services that the child is being paid for. For example, it is unlikely that paying a four-year-old for clerical work would be respected by the IRS, but the child might be effective in providing "modeling" or similar services in company advertisements. Documenting services performed by the child, hours worked, or having an employment contract in place with the child may help substantiate that actual, necessary services were performed.

DO pay the child reasonable and actual compensation.

The child's wages must be reasonable under the circumstances and wages must actually be paid. Paying a child $100 per hour to work as a part-time receptionist may not be reasonable. On the other hand, if the child is capable of performing more skilled or specialized activities, such as a teenager developing the company's website or managing its social media presence, higher wages may be reasonable. Comparing the child's wages to those of other employees or obtaining wage information from unrelated businesses can help a business owner determine what may or may not be reasonable compensation under the circumstances.

The child's wages also must be paid and generally cannot be in the form of support that the parent is otherwise legally obligated provide to the child, such as in food. Again, keeping records of services performed, hours worked, information obtained on wage levels of unrelated businesses, and records that show that pay was provided (cleared checks, direct deposits, etc.) may help substantiate the existence of reasonable and actual compensation.

DO NOT run afoul child labor laws.

Federal laws such as the Fair Labor Standards Act of 1938 (FLSA) and applicable state and local laws generally place restrictions on child labor. Although rules tend to be somewhat less restrictive where the business employing the child is owned solely by the parents of the child, significant restrictions may still exist as to the number of hours that a child may work, when those hours can be worked, the type of work a child may perform, and so forth. Reviewing applicable child labor laws with an attorney prior to employing a child can help avoid significant penalties for violations.

DO NOT forget employment laws.

In addition to special child labor considerations, laws for employing any non-family employee also generally apply. Requirements may include ensuring that the business obtains an Employer Identification Number (EIN) if it does not already have one, having federal withholding (Form W-4) and employment verification paperwork (Form I-9) completed for the child, issuing a Form W-2 to the child, or meeting record keeping and record retention requirements. The business owner's CPA or attorney can provide guidance on the requirements that may be applicable.

DO consider leveraging earned income with a Roth IRA.

A popular wealth building tool for young individuals is the Roth IRA, which can allow for tax-free growth without required minimum distributions during the original account holder's lifetime. Given the potential for extremely lengthy tax-free compounding, Roth IRAs can be especially advantageous for children. However, one of the most significant barriers to Roth IRA contributions by minors (or contributions on their behalf) is a lack of earned income. Roth IRA contributions are only permitted to the extent an individual has earned income (subject to annual contribution limits as well as annual income limits). Employing the child in the business can give the child earned income, potentially opening the door for Roth IRA contributions and tax-free wealth building.

Parents who employ their children should explore these potential benefits and drawbacks with their professional advisors to see how they may apply in their individual circumstances.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.