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Employing a Family Member in Your Business

At some point, almost every small business owner considers hiring a spouse or child in the business. Their availability, flexibility and familiarity can make them attractive employees. There may even be some tax advantages. However, there can also be disadvantages to these types of arrangements.

Income tax issues

The wages you pay an employee for work performed, whether that employee is a relative or not, are a tax-deductible expense of your business. If that family member is in a lower marginal income tax bracket, this type of income shifting can reduce the family unit's total income tax liability.

If you hire and pay a child, the child can use their standard deduction to offset up to $12,400 for 2020 of earned income. In addition, earned income above that amount will be subject to income tax at the normal brackets (starting at 10%). You should note that this type of arrangement can be attractive if the child is under the age of 18, 18 years old with earned income less than half of their support, or 19 to 23 year old students with earned income of less than half of their support. For young children, earned income is not subject to the "Kiddie Tax" like unearned income consisting of interest and dividends.

Using an IRA or a Roth IRA

Once an individual has earned income, he or she can contribute to an Individual Retirement Account. A wage earner can contribute up to $6,000 to an IRA for 2020. Hiring and paying a child can enable the child to get an early start on their retirement. A few years' contributions at an early age can grow dramatically over a long time. In addition, if the child contributes to a regular IRA, the contributions will probably be tax deductible because of their overall low-income level.

It may also be attractive to use a Roth IRA. While the contributions would not be deductible, the ultimate distributions would not be subject to income tax. Forgoing the immediate tax deduction of a regular IRA can be more than enough to offset if the funds are going to remain in the account for a long period or if the tax savings from a regular IRA deduction are relatively small. In the case of a low-income child, a Roth IRA may be more attractive on both points. The money will compound tax deferred for a long time and the savings from the potential deduction is small because of the child's low tax rate.

Payroll taxes

If your business is a corporation, the wages you pay a child or any other relative will be subject to Social Security tax – both at the individual and corporate level. For a spouse, this can be a way to build up the potential Social Security benefits the spouse may eventually be able to receive.

If your business is a sole proprietorship or partnership, the wages you pay a child under the age of 18 are not subject to Social Security taxes. You may also be able to avoid Federal Unemployment taxes for a child under the age of 21.

Other issues

If your business has other employees, you must consider how they will react if you hire a relative. Nepotism can often cause resentment. Avoid this by having the working relative be subject to the same requirements and expectations as any other employee.

Many parental employers are also sensitive to the issue of having their children not viewing a family business job as an entitlement. It is always good to discuss expectations and to have normal feedback on job performance.

Summary

Employing a spouse, child or parent can offer some tax and other benefits if the role is a true working role and the compensation is reasonable. It may be advisable to consult with your tax advisor before embarking on this approach. A family business can be a source of wealth and personal satisfaction. Be sure to have the type of open and honest communications needed with any employer/employee relationship.