Taking Money Out: Putting the Family on the Payroll
Does It Make Tax Sense?

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Should family members be formally put on the business's payroll and paid wages and salaries?

As is so often the case with taxes, the answer is "it depends." It depends on whether the family member is a spouse or someone else. It depends on how the company is organized. It depends on the relative tax brackets of the parties. It depends on what kind of benefit programs the company offers. All of these factors should be considered.

Let's take a closer look at the issues that crop up when deciding whether relatives should be put on the payroll.

Income Tax Deduction

Payments to a relative-employee are deductible for income tax purposes if the payments are for actual services rendered and are reasonable in relation to the services rendered. For example, the IRS has ruled that reasonable wages paid by a parent to an unemancipated minor child who works as a bona fide employee in the conduct of a trade or business or for the production of income can be deducted [Rev. Rul. 72-23]. The payments are deductible even if the child uses them to provide for his or her own support [Rev. Rul. 73-393].

Family Relationship

However, where an employer and employee have a family relationship, the IRS and the courts closely scrutinize the facts to determine whether the payments received were made on account of the employer-employee relationship or the family relationship [e.g., Shelley, T.C. Memo. 1994-432].

For example, in one case, an attorney claimed deductions for wages and benefits paid to his wife. The lawyer contended that his wife performed many valuable services for the law practice, including secretarial, clerical, and bookkeeping services. The Tax Court denied the deduction. The court pointed out that the attorney presented no credible evidence establishing that his wife performed any services other than those reasonably expected of a family member. The court refused to accept the attorney's "self-serving, uncorroborated testimony" that his wife provided valuable services [Haeder, TC Memo 2001-7].

Obviously, in this type of situation, the more proof an owner has of a bona-fide employer-employee relationship, the better. Records of the hours worked, a detailed description of the services performed, and the relevant payroll tax records would be good for starters. An owner may even want to consider setting up a diary spelling out the work performed each day.

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Income Shifting

Assuming the salary or wage payments are deductible by the business, they would, of course, be taxable as compensation to the relative-employee. This has the effect of shifting income out of the business's tax bracket and into the relative-employee's tax bracket.

Whether this income shifting is beneficial depends on the situation. For example, in the case of a self-employed taxpayer employing his or her spouse, nothing is gained by the income shifting if the couple files a joint return. Their combined income is taxed under the single joint return rate schedule. On the other hand, if you are an owner of a C corporation and the corporation employs the individual's spouse, the corporation would be effectively splitting its income with the spouse. If the spouse were in a lower tax bracket than the corporation, there would be a net tax savings.

A net tax savings is more likely when the relative-employee is the individual's minor child. Whether the owner runs the business as a sole proprietorship or as a corporation, the child's earnings are probably taxed at a lower rate than the earnings of the sole proprietorship or corporation (assuming the child's earnings are not subject to the Sec. 1(g) "kiddie" tax).

Payroll Taxes

For 2005, FICA taxes total 15.3 percent of the first $90,000 of earnings. Of this amount, 12.4 percent is for Social Security and 2.9 percent is for Medicare. An employer pays 7.65 percent and an employee pays 7.65 percent through withholding. On compensation of more than $90,000, only the Medicare portion is due. The employer and the employee each pay 1.45 percent.

Through the self-employment tax, self-employed pay the full 15.3 percent tax on the first $90,000 of net earnings from self-employment and the 2.9 percent Medicare tax on the excess. A self-employed calculates net earnings from self-employment by multiplying total earnings by 92.35%. This effectively puts a self-employed on the same footing as an employee who does not pay FICA taxes on the amount of FICA taxes paid by the employer.

If a business owner hires a family member, the payroll tax impact may be negative. For example, suppose the self-employed owner earns $80,000 and hires his or her spouse at a salary of $20,000. This will reduce the owner's net earnings from self-employment subject to self-employment tax from $73,880 (92.35% x $80,000) to $55,410 (92.35% x $60,000), but that will be more than offset by the couple's combined FICA tax on $20,000. The couple's total payroll taxes will climb from $11,304 to $11,537.

If a self-employed individuals net earnings from self-employment exceed the amount subject to Social Security tax, the payroll tax increase will be more substantial. Suppose the individual's total earnings are $120,000. Hiring the spouse at $20,000 reduces total earnings to $100,000 and saves a 2.9 percent Medicare tax on $18,470 (92.35% x $20,000). However, the spouse's $20,000 of salary will be subject to both Medicare and Social Security tax-the full 15.3 percent.

If the individuals business is incorporated, the effect of hiring a family member depends on whether the individual's salary is reduced by the amount of the relative's salary. If the individuals salary is reduced, the effect is similar to that for self-employed above. If the individual's salary is not reduced, then every dollar of FICA tax paid on the relative's salary will be an additional tax dollar owed by the family.

Employee Benefits

With certain employee benefit plans, hiring a family member may have little impact. For example, if an individuals business is incorporated and the corporation provides health care coverage for employees and their families, the individuals spouse and children can receive tax-free coverage whether or not they are employees. However, with other types of benefit plans, putting a family member on the payroll can make a real difference.

For example, suppose the individuals business maintains a qualified retirement plan for its employees. If the owner hires his or her spouse or child, the new employee will be entitled to the same retirement plan benefits as other employees. Note, however, that employers are allowed-but not required--to exclude from the plan all employees under age 21 [IRC Sec. 410(a)(1)(a)]. So the plan would have to be reviewed if the owner is hiring his or her minor child.

As an employee with earned income, a family member will be entitled to make contributions to an individual retirement account (IRA) or have contributions made on his or her behalf. That doesn't mean much in the case of an individuals spouse. IRA contributions can be made for a nonworking spouse (assuming the working spouse is otherwise eligible to make contributions) [IRC 219(c)]. However, in the case of an individual’s minor child, formal employment of the child allows IRA contributions that would not otherwise be permitted. For 2005, up to $4,000 can be set aside in an IRA for the child's future (assuming the child has at least $4,000 of earnings).

Some other potential employee benefits that may become available to family members on the payroll include:

Child care reimbursement plan: If the individuals business reimburses employees under a qualified Section 129 dependent care reimbursement plan, the owner cannot participate unless his or her spouse is “gainfully employed.” [IRC Sec. 129(e)(1); IRC Sec. 21(b)(2)]. However, if the spouse is on the business's payroll-even on a part-time basis-the couple will be entitled to reimbursements (subject to earnings limits; see IRC Sec. 129(b)]. Note that even if the business does not maintain a Section 129 plan, once the spouse is gainfully employee, the couple will be entitled to a dependent care tax credit if they incur child care expenses [IRC Sec. 29].

Group-term life insurance: If the individuals business provides group-term life insurance coverage to its employees under IRC Sec. 79, the individuals spouse or child employed by the business can participate on the same basis as other employees.

Educational expenses: If an employed spouse needs to brush up on the skills need for his or her current job, the individuals business may reimburse the spouse for the education expenses. Such a reimbursement may be excludible from income as a "working condition" fringe benefit [[IRC Sec. 132(a)(3)]. If the individuals business maintains a Section 127 educational assistance plan, an employed spouse or child of the owner may be entitled to reimbursements for college education expenses. However, the reimbursements cannot exceed 5 percent of the plan's total payouts for the year [IRC Sec. 127(b)(3)].

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Travel expenses: Making an individuals spouse an employee may permit the spouse to accompany the owner on a business trip at the business's expense. As a general rule, if an individuals spouse accompanies the client on a business trip and the individuals business picks up the tab, part of the cost is taxable to the client-even if there is a business reason for the spouse's presence. The cost of the trip allocable to the spouse's expenses will not qualify as a working condition fringe benefit because a spouse's travel expenses are generally disallowed [IRC Sec. 274(m)(3)]. However the disallowance rule does not apply if (1) the spouse is an employee of the business and (2) the spouse's presence on the trip services a bona fide business purpose. So, if the spouse is on the payroll, the company's payments for his or her travel expenses may be excludable as a working condition fringe benefit.

As you can see, there is no "one-size-fits-all" answer to whether hiring a family member is worthwhile from a tax standpoint. It all depends on an individual's particular situation.

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