A Case For Business Owners To Hire Family Members

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Americans embrace a multitude of different past-times; baseball, fishing, shopping but one past-time that seems to be a commonality is expressing their grievances about taxes. However, that past-time is undermined by the tax "loop-holes" that are overlooked by business owners who occupy their time by running a successful business, but forget to take the time to speak with a qualified financial expert. In this White Paper, I will address 3 ideas that are often overlooked by business owners that could reduce taxes and maximize savings.

Are Your Family Members Employees?

There are three areas that I am addressing today that are underutilized; Roth IRA, 401k, and Social Security. First is regarding the contributions made to Roth IRAs for children and parents. A successful business owner already understands that if they have Modified Adjusted Gross Income over $179,000, they are not allowed to contribute to a Roth IRA. However, by allowing children to receive earned income, IRS Publication 590 states that contributions may be made to Roth IRA accounts for anyone, of any age as long as they have earned income. In order to contribute the maximum amount to a Roth IRA, that child must have at least $5,000 in earned income (applies for 2012).

Potential Tax Savings... The standard deduction for a person (i.e. a child) for income tax purposes is $5,800. Therefore, if a child's tax return is filed with reportable income of $5,000, their Adjusted Gross Income(AGI) would be $0, and so would their taxable income. Now a practical business owner would identify that they would have to pay FICA and unemployment taxes based on that amount, but in some instances, the business owner would be paying these taxes anyway based on their own income. However, if the business owner is a Sole Proprietor, there is NO payroll taxes paid by the business owner whose children under the age of 18. Therefore, because the business owner passed the income to the children, this income would now be taxed at the child's tax bracket minus the standard exemption which is potentially $0.
A Word Of Caution… CPAs that are reading this are thinking, this is a great idea until an IRS audit. The crucial element in this idea is understanding "job fit for age." If the business owner were to be audited, would that business owner be able to justify to the auditor that the job the child perform was physically able to accomplish and was the compensation fair.

3 Reasons Why... Now to explain why business owners want to contribute to their child's Roth IRA. IRS Publication 970 defines the distributable reason for Roth IRAs. There are multiple reasons but let's address just 3. First is the most obvious, pass through tax-free retirement savings to their child. Due to this being contributed to prior to death, this money is excluded from the business owner's estate. If the child holds and continues to contribute to the Roth IRA, that child at 59 ½ will have a sizable tax free retirement income.

The second is for college expenses. At the age of 5 years old, all parents want their child to grow up and go to college, however, not every child will go to college, and most will not graduate. Coverdell Saving Plans and 529 Plans are great and there are a lot of advantages for higher education, but what if the child does not go to college? The Roth IRA can be more versatile. However, as defined in Publication 970, the money only comes out of the Roth IRA penalty free if used for qualified college expenses. The earnings will become taxable. Therefore, utilizing the Roth IRA for college expenses would be secondary to Coverdell Saving and 529 Plans.

The third reason would be for first time home buyers. Most parents are excited to get their kids off their "tab" and assume responsibility for their own expenses. Parents even go to the extreme to assist their children with the purchase of their first home. What a better gift for the business owner and the child, if the child has a Roth IRA, they may use up to $10,000(as of 2012) towards the purchase of their first home.

What is Work... Now let's address the issue of constitution of compensation to a child. Who says a business owner's child(ren) cannot come work for them. If CEOs can get paid millions of dollars to help a company file for bankruptcy, a business owner can pay a child to come in the office, empty the trash, dust the furniture and perform simple tasks appropriate to their age. This does not have to be limited to children, this could also be extended to a spouse and or to parents.

Let's Not Forget About Dear Mom and Dad... The tax savings and potential asset savings doesn't end with just children, what about parents of the business owner. Providing earned income not only gives the business owner a tax deduction, it also allows the parents to make contributions to a Roth IRA. By paying them enough to make the contribution ($12,000 in 2012), it would not affect Social Security Income, nor should it have a negative effect on their taxable income. For the average reader they may be thinking "Why would I want to contribute to my parent's Roth IRA, it's my money I need to save." So my question is "What happens to the money when they pass away?" As the sole beneficiary of the Roth IRA, that money would then pass tax free into the beneficiaries Roth IRA, hence the same effect if the business owner made the contributions themselves. How about this question, "What if my parents run out of their money?" Well, if they run out of money prior to their departure, the business owner would probably be spending their after-tax money to support them anyway. Therefore, they would be utilizing tax free savings and earnings from the Roth IRA.

Double Favor For Family Employees ... In Texas, most public education employees do not pay into Social Security, however, I have found that most have paid into Social Security prior to or through extra employment. The fact is that the spouse may be short of receiving the 40 credits required to receive Social Security or they may have over 20 years of service credits and are starting the climb to receiving their maximum amount from Social Security through the Windfall Elimination Provision.* There is a breakeven point in which the business owner would want to stop contributing. A qualified financial or tax advisor should calculate this point prior to the business owner initiating this strategy.

The 401K Advantage... Successful business owners whose earned income is over $115,000 know the pains of tax deferred saving through their company's 401k plan can be complicated. However, in many cases, by just having a family member added as an employee, testing issues will decrease or in some instances be eliminated. According to the IRS, family members that are employed by a company who are related to a Highly Compensated Employee(HCE), are also considered HCEs regardless of their compensation. Therefore, if that family member declines to contribute to the plan, HCEs, in most cases, will be able to contribute more and could possibly be allowed to "max" out the plan.

Millions of dollars are left on the table from government programs just because individuals don't take the time or opportunity to research. When I was in public accounting, we found it quite humorous when one of our celebrity clients received Earned Income Credit. The tax system is built for individuals that understand the law to save on income taxes. Those individuals that should be in-tune with these strategies and more are your qualified Financial and Tax Advisors. I encourage all readers to contact a qualified advisor and ask how they can help determine if you are leaving money on the table. If you have any questions or feel your advisor is not qualified enough to answer your questions, please feel free to contact Kyle A. Sadler, AIF® at 281-973-9290.

Kyle A. Sadler, AIF® is an Accredited Investment Fiduciary that utilizes a specialization in administration, design, and education of 401k plans. With over 13 years of experience in the group plan industry, he has set himself apart by going above and beyond what average advisors' education in this field.

**Windfall Elimination Provision information can be found on www.ssa.gov*