



But My Kids Are Worth It! Problems with Children on the Payroll
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How Not to Get A Deduction for Paying Your Children

This week we'll look at an instructive case that dealt with the a taxpayer who tried to claim a deduction for wages paid to each of their four children in two separate businesses—and lost the entire deduction in all cases. The case we'll look at is the case the *Alexander v. Commissioner*, TC Summary 2006-127, issued this past week.

There are a number of obvious reasons why parents may wish to pay salaries to their children. For one, there's the initial issue that the children are normally in a lower marginal tax bracket than their parents—so paying the children a salary reduces the parent's income from the business and transfers that income to the children at a lower tax bracket.

As well, since the children have earned income, they can fund retirement accounts using these funds to justify the contribution. Given the long-term growth that the funds will enjoy in a tax advantaged account, this can produce a major long term financial benefit to the children even if the contributions are relatively modest. With the addition of Roth IRAs, such accounts may be even more attractive since the children's income may be low enough that none of the salary will be subject to income tax.

The law also provides a FICA/self-employment tax break for employing minor children in your sole proprietorship (though not in your wholly owned corporation). The payments to minor children by the parent's business are not subject to either FICA or FUTA taxation [IRC §§3121(b)(3)(A) and 3306(c)(5)]. However, assuming the wages are found to be legitimate, they will reduce the amounts subjected to self-employment tax on the parents' returns.

Finally, the parents may be able to provide various employee benefits to their children via the business, benefits that may be tax advantaged when paid to an employee even if not available to a sole proprietor directly (such as medical reimbursement plans, as we discussed in an earlier podcast).

What's Needed for the Deduction

But all of this may be lost if the deduction cannot be defended.

The key to making sure the payments qualify is to insure the payments meet the basic tests of §162 for business expenses and the wages related to the same. The provision starts out immediately with the following:

(a) In general

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

To sustain the deduction, we must be able to show that these wages truly related to the business in question and that they were a reasonable amount for the services actually rendered.

As well, you have to fend off the related question of whether the payments are truly a payment for personal items under §262(a). That provision provides:

(a) General rule

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Payments to the children are subject to special scrutiny due to the fact that the parties are closely related—so the court won't assume there have been arms length negotiations that arrived at the working relationship or the payments to be made. The court in the case we are looking at this week came up with the list of the following factors that might lead to a finding that the payments are not true wage payments to the children:

- *Failing to pay employment taxes and file information returns with respect to the child*—if the parent ignores the obligation to file payroll tax reports, including the annual Forms W-2, that would suggest the payments weren't truly wages. Even if the payments are exempt from FICA and FUTA taxation, W-2s still have to be filed for the children and the wages included as non-FICA wages on the Forms 941. Since an employer generally does not “forget” to issue W-2s for unrelated employees, the failure to do so makes it appear that these employees are not really considered employees by the parents.
- *Paying the child a flat amount determined at the beginning of the year that is not based on the services actually performed*—employers generally base the amounts paid on the services an employee will actually perform. If each child “just happens” to earn an amount that is at the level the child can earn without triggering taxation, it suggests that the services aren't really the driving force behind the compensation being paid.
- *A lack of correlation between the dates and amounts of payments and the hours allegedly worked by the child*—employees generally are paid relatively close to the date they perform the services in question. Employers do not generally pay the compensation months before or after the services are rendered. Again, doing this makes it seem as if there's no real connection between the services being performed and the amount of wages paid.
- *Failing to maintain adequate records of the child's hours worked and amounts earned*—employers will generally maintain records both of the hours worked by the employee and specific amounts earned each period. Of course, if the payment has nothing to do with the services performed then no such record would be kept—which is exactly what the court is suggesting this implies about the actual relationship.
- *Compensating the child for services which are in the nature of routine family chores*—this issue goes directly to the issue of whether the payments are for services that are personal in nature and would therefore be subject to disallowance under §262(a).

The Alexander Case

In the case of *Alexander* the taxpayers failed on a number of fronts to justify the deduction for the wages paid to their children. The fact that the businesses the children “worked” for both had losses that were created largely by the payment of wages to the

children probably did not help their cause in front of the court, though the opinion doesn't reference that as a factor in the disallowance.

The Alexander's 21 year old adult son, Steven, worked in his mother's seamstress business in the summer when he returned from the college for the summer. According to the records the Alexanders kept (on a note they stuck on their refrigerator), Steven worked 378 hours during the summer. The business had total income for the year of \$1,301 and reported expenses of \$4,666 of which \$4,000 of the expense represented the salary paid to Steven.

While Steven was only available to work during the summer, he was paid throughout the year, paying \$481 in January through April, and \$2,256 in November and December. The work Steven did included purchasing supplies, drafting sewing patterns and cleaning his mother's work space. His mother testified that she decided at the beginning of the year that she could afford to pay Steven \$4,000, which ended up being what she paid him.

Steven, being over age 18, would have been subject to FICA and FUTA. However, the Alexanders did not file payroll reports to pay these taxes and did not issue a W-2 form to Steven at the end of the year.

The Tax Court sided with the IRS in disallowing the deduction for Steven's wages in full. After detailing all of the issues involved, the Court summarized its conclusions on Steven as follows:

On the basis of all of the facts and circumstances, we conclude that the payments to Steven represent personal, living, or family expenses. See sec. 262(a). The tasks that Steven performed are mostly in the nature of routine family chores. Petitioners predetermined the amount they would pay him and failed to observe the formalities of the employee-employer relationship, such as paying employment taxes, filing information returns, and paying Steven promptly for the hours he worked. Thus, petitioners cannot deduct the payments to Steven as wage expense. Respondent's determination is sustained.

Next the Court looked at the payments to the Alexanders' minor daughters. The Alexanders had three daughters, one aged 17, one 9 and one 8. The daughters all worked in dog breeding business that Mrs. Alexander also conducted. They claimed a deduction for \$4,250 for wages to each of the daughters (which just happened to be the standard deduction for the year in question), for a total wage deduction of \$12,750. As all of the daughters were under age 18, no FICA or FUTA was due—but, again, the Alexanders did not issue W-2s to their daughters.

Again the wages dwarfed the income from the activity. The dog breeding business reported total income of \$4,900 and expenses (including the daughters' salaries) of \$16,007—so, in a second business, the wages to the children pushed the business into a net loss position.

In this case, they did not pay their daughters in cash (they had generally paid Steven in cash). Rather, they kept a running total of the daughters' earnings during the year and as the daughters wished to purchase certain items, their account was charged for the amount of the purchase. The daughters were allowed to overdraw that account, which was treated as an advance on their earnings. The daughters duties included cleaning the dogs and the yard in which they exercised, putting up fencing, taking out the garbage and caring for newborn puppies.

Mrs. Alexander at one point claimed the daughters were paid \$7 an hour, though at another point she stated they had again determined what they could pay at the beginning of the year. The court indicated they did not believe the \$7 an hour testimony, because it would have been a tremendous coincidence for each daughter to have worked an identical number of hours, and for that work to have also coincidentally worked out to a wage that was exactly equal to the standard deduction—the maximum amount they could have earned without paying tax.

The Court again sided with the IRS and disallowed the wage deduction. The Court noted:

On the basis of all of the facts and circumstances, we conclude that the payments to the daughters represent personal, living, or family expenses. See sec. 262(a). Petitioners failed to issue Forms W-2 and predetermined the amounts they would pay their daughters. The daughters' tasks were mostly in the nature of routine family chores, and there was a lack of correlation between the payments they received and the hours they worked. Accordingly, petitioners cannot deduct the payments to their daughters as wage expense. Respondent's determination is sustained.

Finally, the Alexanders attempted to rescue the deduction by claiming an IRS employee had told them that their proposed payment of wages to their children was fine under the tax law. The Court noted that, in general, the IRS is not bound if its employees give an erroneous interpretation of the law to a taxpayer absent unusual facts. The Court went on to note the conditions that would have to be satisfied to have those unusual facts that would justify applying equitable estoppel:

The following conditions must be satisfied before equitable estoppel will be applied against the Government: (1) A false representation or wrongful, misleading silence by the party against whom the opposing party seeks to invoke the doctrine; (2) an error in a statement of fact and not in an opinion or statement of law; (3) ignorance of the true facts; (4) reasonable reliance on the acts or statements of the one against whom estoppel is claimed; and (5) adverse effects of the acts or statement of the one against whom estoppel is claimed. *Id.* In addition, the Court of Appeals for the Ninth Circuit requires the party seeking to apply the doctrine against the Government to prove affirmative misconduct. *Miller v. Commissioner*, T.C. Memo. 2001-55.

In this case, the taxpayers did not show that these facts applied to the claimed erroneous advice received.

Lessons of Alexander

It's easy to dismiss the *Alexander* result as a case that proves the old tax adage that “pigs get fatter, hogs get slaughtered” as their wage deductions appear to go far into hog territory. But the concepts the court outlined are still important to pay attention to whenever a related individual is hired.

Back in February, a podcast discussed a case that had a very different result—the case of *Speltz v. Commissioner*, TC Summary 2006-25. But it's also useful to note that even in that case where the taxpayer had solid records and information to support the wage payments to the spouse, the IRS still litigated the case.

For that reason, it's extremely important not to make any of the five “major errors” that the Court outlined in the *Alexander* decision.