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How Putting a Family Member on Your Payroll Can Save on Taxes

There have always been good financial reasons for putting members of your immediate family on your business payroll where they can and do provide meaningful services. These reasons include:

- Income splitting - spreading the net income from your business among several family members can reduce the effective tax rate on that income.
- Increased Tax Deductions - up to \$16,500 in salary paid to a family member can be fully sheltered in a 401(K) plan.
- Medical Coverage - family members who meet participation requirements can be covered under the business' medical insurance.
- Social Security Benefits - family members who receive a minimum of \$4,000 in salary in any year get one year's credit towards qualifying for Social Security Benefits, which in some circumstances can make the difference between qualifying for benefits and not qualifying.

However, in March of this year Congress made hiring family members even more attractive when it passed the Hiring Incentives to Restore Employment Act (“HIRE”), which got little press in the din surrounding health-care overhaul. Under HIRE employers get to skip paying 6.2% in Social Security taxes on wages paid to employees hired after February 3rd for the period from March 19th through the end of the year. This equates to a tax savings of almost \$2,500 on \$40,000 in salary. And if the new employee stays on the payroll for a year, the employer can get an extra dollar-for-dollar tax credit of up to \$1,000 on its 2011 tax return.

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The application of HIRE to family members is somewhat complicated, and primarily depends on the type of legal entity through which the business is conducted. Generally speaking, the rules work as follows:

- Sole proprietors - can claim HIRE benefits from hiring a spouse but not other relatives.
- Partnerships (including LLCs and LLPs) - here the rules get more complicated;
 - If the only partners are a husband and wife, the partnership doesn't qualify for HIRE benefits for hiring a relative.
 - Partnership doesn't qualify for HIRE benefits for hiring relatives of a partner who has more than a 50% interest in the partnership.
 - Partnerships with two or more unrelated partners, none of whom owns more than a 50% interest, are free to hire their spouses and relatives and take HIRE benefits.
- Corporations (both "S" and "C") - are subject to rules similar to partnerships;
 - Corporations don't qualify for HIRE benefits for hiring relatives of a shareholder who owns, directly or indirectly, more than 50% of the stock.
 - In determining the ownership of a corporation, shares owned by other family members are aggregated, so a corporation 100% owned by four siblings can't qualify for HIRE benefits for any of their relatives.

Of course, failing to meet the foregoing standards doesn't prevent you from hiring a relative, it just means you won't be eligible for the HIRE tax breaks.

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