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Employing Children in the Family Farming Business

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Background

In many family farm businesses, the children of the business owner are rendering services during teen years that can be reasonably compensated. These wages produce a business deduction to the farm entity/employer and often may be tax-free to the recipient child.

Earned Income of Dependent Children

The standard deduction of a dependent child is allowed in full against the child's "earned income." Thus, for 2017, salaries and wages and other earned income of the child are exempt from income tax up to $6,350. "Earned income" includes salaries and wages which are subject to Federal Insurance Contributions Act (FICA) tax, as well as wages statutorily exempt from FICA tax (e.g., compensation paid by a proprietor to a child under age 18 per I.R.C. § 3121(b)(3)(A)). It also includes commodity wages exempt from FICA tax under I.R.C. §3121(a)(8)(A). The kiddie tax, potentially affecting the unearned income of those under age 24, is inapplicable to earned income.

Special FICA exemptions

Parental employment and in-home domestic services. There is no FICA tax on wages received by a child under age 18 for services in the employ of a parent, such as where the parent conducts a proprietorship which engages the services of the child.[1] FICA tax also does not apply to wages paid to a child under age 21 for in-home domestic services in the employ of a parent.[2] This FICA tax exemption does not extend to a corporation employing the child of the shareholder, even if the parent owns 100 percent of the corporation. However, if a partnership is owned 100 percent by the spouses, the FICA tax exemption applies in the same manner as if the parent were a sole proprietor.

Funding a Roth IRA

While in-home domestic services produce no deduction for the parent as payor of the wage, the earned income received by the child will generally be free of income tax if it is less than the standard deduction amount. However, this earned income allows the child to fund a Roth IRA. The business or farm

[1] I.R.C. §3121(b)(3)(A).
[2] I.R.C. §3121(b)(3)(B).

employment of the proprietor's child under age 18 provides a tax deduction for the parent. Similar to the domestic employment, the earned income of the child allows the child to fund a Roth IRA.

Example. Al, a farm proprietor, employs his son, Tim, for four years for various farm duties and summer work while Tim is in high school. Those wages are free of FICA, because they represent employment of a child under age 18 by a parent. Tim is compensated and invests in a Roth IRA in the amount of $2,000 for one year, $3,000 for a second year, and $4,000 for two years (total of $13,000). When Tim graduates from high school and enters college, this Roth IRA account has grown from $13,000 to $16,000 (i.e., $3,000 of total earnings).

There are several options available with respect to this IRA:

- Withdraw the full $16,000, in which case $3,000 is reportable in Tim's return as ordinary income but is exempt from the 10% early withdrawal penalty, assuming that all funds are expended on Tim's higher education costs However, kiddie tax would likely be incurred on the $3,000 if Tim was a full-time student under age 24.
- Withdraw only the $13,000 of basis tax-free; continue to defer the $3,000 of earnings and eventually withdraw tax-free and penalty free up to $10,000 when Tim acquires his first residence.[3]
- Allow any undistributed earnings, and possibly principal, to continue to compound for Tim's retirement.

Funding College

Many farmers are in a unique position to fund their children's college education in an exceptionally tax-efficient manner. Cash method farm proprietors and partners can make gifts of unsold grain, while incorporated farm businesses often have the ability to pay compensation for services rendered by children of the owners. The taxable income generated by these commodity sales (even if subject to kiddie tax) and compensation amounts in the child's return can in turn be offset by education credits. If the child's dependency exemption should be claimed in the parental return (such that any college tax credits are to be claimed in the parents' return), the parents can make the election to drop the child's dependency exemption from their return to allow the use of the college credits within the child's return.[4] The election to forego the child's dependency exemption may not be detrimental to parents who face the phase-out of personal exemptions.

Example. Bob, a high-income farmer, has a daughter, Beth, who was a high school senior-college freshman during calendar year 2016. Because Beth did not provide over half of her own support and because she is a student under age 24, she is eligible to be claimed as a dependent in Bob's return. However, Bob electively declines to claim Beth as a dependent in his tax return, so that his daughter is eligible to claim either the American Opportunity Tax Credit (AOTC) or Lifetime Learning Credit in her federal income tax return. Assume that Beth has $6,000 of ordinary income during the year from wages and $15,100 of short-term capital gain from grain sales (received as a gift from Bob). Further, assume that sufficient tuition for college was paid to qualify for a maximum AOTC of $2,500.

By declining to claim Beth's exemption in the parental return, the AOTC is available in Beth's return, calculated as follows:

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[3] I.R.C. §72(t)(2)(F).
[4] Treas. Reg. §1.25A-1(f).

Beth's 2016 Form 1040:

Wages…………………………………………………………………..	$ 6,000
Short-term gain on grain sales………………………………………….	15,100
AGI…………………………………………………………………..	21,100
Less 2016 std. ded. (limited to earned income)…………………………..	(6,000)
Taxable Income……………………………………………………….	$ 15,100
Income Tax (including the kiddie tax of $3,250)………………………….	3,460[5]
Less education credit (maximum)………………………………………….	(2,500)
Net Tax…………………………………………………………………..	$ 960

The parent's election to decline the child's dependency exemption does not shift the exemption to the child. The child remains ineligible for the exemption by reason of the eligibility of her parents to claim the exemption. I.R.C. §151(b)(1).

American Opportunity Tax Credit (AOTC) for 2012-2017[6]

The American Taxpayer Relief Act of 2012 extended the AOTC through 2017. The credit is available for the first four years of college, and provides a maximum tax credit of $2,500 (100% of the first $2,000 of tuition and related expenses and 25% of the next $2,000 of tuition and related expenses). The enhanced credit phases out at AGI of $80,000-$90,000 on a single return and $160,000-$180,000 on a joint return.[7] This phase-out range is not adjusted for inflation.[8]

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[5] The "kiddie tax" is computed by taking the income tax rate applicable to the parents (here, assumed to be 25 percent) and multiplying it by $13,000 (the short-term gain on the sale of grain less the $2,100 kiddie tax exemption. That result is $3,250. To that amount is added $210 which is obtained by taking taxable income of $15,100 less the $13,000 amount that is subject to the kiddie tax. That result is $2,100, which is then multiplied by the child's tax rate (here, assumed to be 10 percent or $210. The end result is $3,460.

[6] I.R.C. §25A(i).

[7] I.R.C. §25A(i)(4).

[8] 40 percent of the credit, to a maximum of $1,000, can be refundable, unless the taxpayer is an 18-23 year-old who would be subject to kiddie tax.