

Complying with the Law When Employing a Nanny

HIRING A NANNY LEGALLY requires close consideration of several employment law, tax, and insurance issues. The process may appear daunting at first, but the resolution of the issues ultimately is not as complicated as many fear and yields benefits for employers and employees.¹

Federal and California law are straightforward. In almost all cases, a nanny who works in a family's private home is an employee, not an independent contractor.² Determining whether or not a person is an employee depends upon the degree of direction and control the supervisor exercises over how the person performs his or her duties.³ The IRS presumes that a family will exercise a significant degree of control over how a nanny cares for the family's child.⁴ Thus, the IRS deems almost all nannies to be employees, not independent contractors, requiring the household employer to pay employment taxes for the nanny's work on the employer's behalf.

The degree of exclusivity of employment is another indicator of a person's employment status. For example, the fact that a nanny works exclusively for one family and no other employer indicates that the nanny is an employee, not an independent contractor.⁵ However, even if a nanny works for multiple employers, that does not necessarily make her an independent contractor. Instead, the more likely assessment is that the nanny is an employee of more than one employer.

There are limited exceptions to the nanny-as-employee rule. One of the most common arises when a parent pays an agency directly for the nanny's services. When this occurs, usually the agency, not the parent, is the nanny's employer, presuming the agency controls what work is done and how the work is performed.⁶ Similarly, if a parent brings the child to the home of a nanny for supervision, and especially if the child is not the only child supervised in the nanny's home, the most likely conclusion regarding the status of the nanny is that she is offering her services to the general public and she is an independent contractor, not an employee of the child's family. Certain family members—such as a spouse, children under 21 (unless being a nanny is their principal occupation), and parents (under certain conditions)—generally are not classified as employees. Finally, if the nanny exclusively controls how and when she works, and works for several households, she probably is an independent contractor rather than an employee. This is a very rare circumstance.⁷ How a nanny refers to herself, how her status is defined in an employment contract, and how she is paid (hourly or salaried) do not alter the criteria for determining her employee status.

Circumstances of Discovery

Many people believe that as long as a nanny does not report her employer to the authorities, the employer will not get caught hiring someone "under the table." Recent history and the criminal docket are littered with people laboring under this misconception.

A terminated nanny's reporting of an employer to the IRS is one way authorities learn of a nanny working illegally. Still, this is hardly



the only way people get caught not complying with applicable laws. To the contrary, the far more common circumstance in which the government discovers that a nanny has been working under the table involves an amicable parting between a nanny and her employer. When the nanny applies for government benefits after the parting, she discovers she cannot have access to them. In the process, the government may discover the illegal employer.

Indeed, the scenarios that illuminate how an individual—the parent or other family member that will be designated as the employer of the nanny—will eventually be uncovered and penalized are legion. Some, however, are more common than others. First, an employer can be snared when a recently laid off nanny files for unemployment benefits. When asked about her last place of employment, she names her former employer—but the employer never paid employment taxes for the nanny.

Second, a nanny may be injured while working in the employer's home and files for workers' compensation. Because the employer hired

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the nanny illegally, the employer did not obtain workers' compensation insurance. The nanny files a report in order to obtain benefits, and the employer is uncovered.

Third, a nanny reaches an age at which she wants to retire. When she files for Social Security, her benefits are lower than she expected, and she realizes that during the time she worked for her employer illegally, no Social Security contributions were made. In an attempt to receive more benefits, she reports her employment status to the Social Security Administration.

Fourth, an employer tells the nanny that, as an independent contractor, she is responsible for her own taxes. When the nanny's tax bill comes due, she realizes that she is responsible for both the employer's and employee's share of Social Security and Medicare. Clearly her tax bill is much larger than she expected, and she complains to the IRS.

These are just the examples of the unintended discoveries of employers acting illegally. The nannies in these scenarios ostensibly are merely seeking compensation and redress. They do not include a disgruntled nanny, upset over some slight, who quits and turns the employer in herself—or worse yet, tries to blackmail the employer. Or the neighbor, coworker, or family member who is envious or has a grudge against the employer and decides to alert the appropriate authorities about the employer. Or perhaps the IRS decides to audit the employer, notices the large amounts of cash or checks flowing out of the employer's bank account every two weeks, and gets suspicious.

Under any of these scenarios, the result is the same: The employer gets caught and faces considerable consequences.

Penalties for Employing a Nanny Illegally

Some people believe that as long as they do not intend to seek political office or pursue other lofty professional aspirations, they do not have to worry about the consequences of hiring a nanny illegally. However, the criminal and financial repercussions are severe and have a negative effect on personal reputations far beyond the quashing of career goals.

As a threshold matter, employers must report household employment taxes on their personal federal tax returns.⁸ Federal law requires the employer to pay his or her own taxes as well as remit the employee's taxes that are collected by the employer to the federal government.

The intentional and willful failure to pay or remit the appropriate taxes constitutes a criminal violation of the federal tax laws. The penalties include fines of up to \$100,000 and imprisonment for up to five years.⁹ Even

in the absence of a criminal prosecution, an individual may face civil penalties and fines, including the payment of all back taxes with interest.

Further, if an employer advises or attempts to dissuade a nanny from paying her taxes, such conduct could constitute an additional tax crime and conspiracy, with penalties of three and five years' imprisonment, respectively, as well as a maximum of \$250,000 in fines on each charge.¹⁰ Independent of criminal action, there is no statute of limitations for failure to report and pay federal employment taxes.

Attorneys face particular professional consequences in addition to these civil and criminal penalties. For example, Business and Professions Code Section 6068(o)(4) requires attorneys who are charged with a felony, such as tax evasion, to report the charge to the State Bar. This requirement has the potential to jeopardize an attorney's ability to practice and earn a living.

Of course, if a person is attempting to become a judge or seeking elected or appointed office, having a "nannygate" problem can lead to undesirable publicity that can damage a reputation and career, as Zoe Baird, Kimba Wood, Linda Chavez, or Bernard Kerik—political appointees who ultimately had to withdraw their names from consideration due to issues over household workers—can attest. Moreover, all attorneys—even those uninterested in political office or an appointment to the bench—trade on their reputation for integrity, and being labeled a tax cheat is not good for anyone's business.

Finally, in addition to the criminal penalties and the impact on the employer's professional reputation, the employer under a cloud faces the expenditure of substantial fees for the services of lawyers and accountants in mounting a defense in a regulatory proceeding, audit, or criminal prosecution. Given the likelihood of the employer's getting caught and its significant costs and consequences, hiring a nanny illegally is not worth the risk.

Advantages of Hiring a Nanny Legally

Despite the common misconception that hiring under the table is financially advantageous, employing a nanny legally provides many economic benefits for both employers and employees. Household employers can save taxes by putting up to \$5,000 pretax per family¹¹ per year into a Dependent Care Account.¹² Household employers can then draw down upon their contributions to a DCA to pay their household employees to care for a child or dependent. This technique, depending on the household employer's effective tax rate, could save hundreds or even

thousands of dollars in taxes while the household employer uses the pretax money on eligible dependent care expenses, including paying a nanny.

Household employers also may be eligible to claim the federal Childcare Tax Credit.¹³ For 2005, the CTC, if applicable, allows the household employer to receive a minimum tax credit of 20 percent of the first \$3,000 in qualifying expenses per year for each of the employer's first two children under age 13. Significantly, the CTC is a tax credit, not a deduction, and therefore directly reduces the employer's tax bill. Further, the 20 percent credit of the first \$3,000 in qualifying expenses is the minimum percentage credit; it cannot be decreased (even for higher-income earners), and the percentage increases for lower-income earners, with a potential savings of even more money.

Employers should take note that, in most circumstances, an employer can use either a DCA or the CTC but not both.¹⁴ Generally the tax savings from a DCA outweigh the CTC tax savings. For example, assuming the employer qualifies for the minimum 20 percent CTC credit, the maximum tax credit for one child would be \$600 (20 percent of \$3,000).¹⁵ In contrast, assuming an effective tax rate of 20 percent, the tax savings of utilizing a DCA to shelter \$5,000 of pretax income would be \$1,000, significantly larger than the \$600 credit of the CTC.

An exception to the rule requiring an election of either a DCA or the CTC occurs when an employer has two children under age 13 and \$6,000 in child care expenses. In this instance, the employer can apply the first \$5,000 of expenses toward a DCA (reaping the tax savings on the full \$5,000) and the remaining \$1,000 of expenses toward the CTC for an additional minimum credit of \$200. This combination, however, is the absolute maximum savings. Employers with more children or higher expenses cannot garner any additional tax savings through a DCA or the CTC.¹⁶

Another lesser known and little understood advantage to hiring legally is improved cash flow. Specifically, contrary to popular perceptions, employers typically pay out less each pay period when they employ a nanny legally. By withholding a nanny's personal income and employment taxes, the employer's weekly out-of-pocket cost to pay a nanny legally is often lower than what the employer would have paid illegally in a gross amount. For example, instead of paying out \$500 under the table every week, the employer might pay out only \$430 weekly to a nanny after withholding applicable taxes. Thus, although the employer ultimately will pay these withholdings to the state and federal governments later in the year, especially if the

employer pays his or her taxes annually, the employer can reap the time value of holding this \$70 difference and improve his or her weekly cash flow.

Hiring legally also allows a household employer to obtain proper insurance for injuries occurring in the employer's home. An employer who pays a household employee under the table runs the risk of the employer's homeowner's insurance turning down a potential claim on the grounds that the employee was hired illegally.

Conversely, hiring legally allows an employer to obtain workers' compensation insurance as part of the employer's homeowner's insurance. This access to insurance is a significant benefit that can protect the employer from the significant costs that would be incurred if a household employee were injured on the job and the insurance company refused to provide coverage based on the insured's failure to disclose or the illegal nature of the activity.

Finally, although it is not a quantifiable benefit, peace of mind matters. Employers of household workers should not underestimate the personal and professional toll caused by worry over getting caught for an illegal hire. By complying with the appropriate requirements, employers of nannies can spend more time with their families and sleep well at night knowing that they have done everything right.

For a nanny, there are several significant advantages derived from working legally. These include access to unemployment and disability insurance, workers' compensation, and Medicare and Social Security benefits. A nanny also may qualify for the federal earned income credit, which could result in her receiving a tax credit larger than the amount she paid in taxes.

Moreover, there are larger financial incentives for a nanny to work legally. By working for an employer who acts in compliance with the laws involving household workers, the nanny can establish an employment history—a necessity if she wishes to make a major purchase requiring credit, such as a car or a home. In addition, an employer's withholding of a nanny's state and federal taxes helps the nanny to properly budget for her tax bill and avoid potential penalties for insufficient withholding.

Finally, paying a nanny legally demonstrates respect for her and the important job she performs caring for a family's children. A nanny is a role model for the children with whom she works, and honesty and integrity are important values for her to impart in how she conducts herself.

Employers should ask themselves these questions: If a nanny is willing to lie to the government about her taxes, is she willing to

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lie to her employer as well? If so, what is she willing to lie about?

Greatest Misconception

Perhaps the greatest misconception about employing a nanny legally is that it will significantly increase an employer's costs. However, when considering the additional costs and the considerable potential tax savings, the extra net cost of hiring a nanny legally is typically 5 percent or less of the nanny's annual compensation.

The additional costs to the employer as a percentage of the nanny's salary are 1) 7.65 percent for the employer's share of Social Security and Medicare, and 2) 1.5 percent for state and federal unemployment and training taxes. Thus, the total tax burden—without considering any of the tax advantages—of hiring a nanny legally is slightly more than 9 percent. However, by maximizing tax savings with a DCA or the CTC, the cost of hiring legally decreases dramatically.

An example best illustrates the true cost. The tax burden of approximately 9 percent on a nanny's \$20,000 annual salary likely would cost her employer roughly \$1,800. However, the employer could shelter \$5,000 pretax in a DCA and use this money toward paying the employer's nanny. Assuming the employer's effective tax rate is 20 percent, the employer's tax savings from the DCA would be \$1,000. Subtracting this \$1,000 savings from the roughly \$1,800 paid in taxes yields an effective cost of approximately \$800, or about 4 percent of the nanny's annual salary. Thus, following the example, the bottom line cost of hiring someone legally is approximately 4 percent more than an employer would have paid if the employer were paying under the table. This is a small price to pay for the peace of mind that comes with hiring a nanny legally.

Written Employment Agreement

Once an employer decides to hire a nanny, it is advisable for both parties to enter into an employment agreement. This agreement should outline a nanny's terms of employment and specify how the employer expects her to care for the children. Although an agreement is not legally required, it is enforceable and greatly reduces the potential for disputes.

This agreement should contain provisions regarding the nanny's job duties, compensation, vacation and sick days, and holidays. It should describe how vacation and sick days are accrued and set limits on the number of available days. The agreement also should provide guidelines for releasing the children to the care of others, or administering medication, and should specify how the nanny should handle emergency situations. A confidentiality provision regarding the employ-

er's household affairs is advisable. A hold harmless provision and release of liability for tax issues can be included as well. The agreement also should confirm the nanny's at-will employment status.

The agreement may be complex and is not similar to employment agreements outside the household setting. Employers should make sure that the document is tailored specifically to ensure compliance with all applicable laws and to address all household employment issues. For example, the nanny's duties should be drafted so that she qualifies for California's daily overtime exemption.

Although hiring a nanny legally can seem overwhelming, it need not be. The rules are clear and relatively unambiguous. Additionally, there are numerous advantages to both employers and employees when the employment relationship complies with applicable law and avoids the costly consequences of the employer getting caught hiring the nanny under the table. Employers of nannies should always remember that paying employment taxes is not an option—it is the law. ■

¹ For an earlier discussion of the issues presented in this article, see Robert E. King, *Thinking about Hiring Your Nanny under the Table? Think Again*, ORANGE COUNTY LAWYER, June 2003, at 38.

² See IRS PUBLICATION 926, HOUSEHOLD EMPLOYER'S TAX GUIDE; CALIFORNIA EMPLOYMENT DEVELOPMENT DEPARTMENT (EDD) PUBLICATION DE 8829, HOUSEHOLD EMPLOYER'S GUIDE; and EDD INFORMATION SHEET DE 231L, HOUSEHOLD EMPLOYMENT.

³ IRS PUBLICATION 926, *supra* note 2.

⁴ *Id.* (specifically citing nannies as an example of household employees).

⁵ See EDD PUBLICATION 8829, *supra* note 2 (noting that persons who offer their services to the general public—and who therefore normally work for multiple individuals—usually are not considered to be employees).

⁶ IRS PUBLICATION 926, *supra* note 2.

⁷ See generally IRS PUBLICATION 926 and EDD Publication DE 8829, *supra* note 2, for descriptions of exceptions to the nanny-as-employee rule.

⁸ IRS PUBLICATION 926, *supra* note 2.

⁹ See 26 U.S.C. §§7201, 7203, 7206.

¹⁰ 26 U.S.C. §7206(2), 18 U.S.C. §371.

¹¹ Because the \$5,000 limit is for a family, both spouses cannot put \$5,000 each into a DCA.

¹² A DCA is normally offered through an employer. Thus, household employers should contact their own employers to determine if they offer such a plan. Enrollment in a DCA is usually limited to a certain time after a qualifying event such as the birth of a child or change in family circumstance. Household employers should not delay in inquiring with their own employers about the availability of a DCA or they might not have the ability to enroll in one until the next annual open enrollment period.

¹³ The decision to use a DCA or the CTC involves many variables. See IRS PUBLICATION 503, CHILD AND DEPENDENT CARE EXPENSES.

¹⁴ IRS PUBLICATION 503, *supra* note 13.

¹⁵ *Id.*


¹⁶ A household employer cannot claim either the DCA or the CTC if the employer or the employer's spouse permanently stays at home with a child or dependent and that employer or spouse is not actively looking for work.

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