

The Case for Paying the Nanny Tax

By Sue Shellenbarger, The Wall Street Journal Online

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Of all the touchy issues I've covered in my 14 years as a family columnist, none send more parents running for cover than the nanny tax.

Parents are willing to discuss nearly anything, in my experience, except whether they pay the nanny tax: the Medicare, Social Security and other payroll taxes that are required of employers with household workers.

An increasing number of parents aren't paying such taxes -- largely because of the rising cost of child care. Filings of the nanny-tax form, Schedule H, fell 4.9% in 2003 to 239,810. That was down 24% from 1997, implying a high scofflaw rate. The Labor Department counts 746,000 household employees, including nannies and housekeepers; many more doubtless go uncounted.

But avoiding the nanny tax is a short-sighted mistake. Even if you don't aspire to political office, as did Bernard Kerik, the cabinet nominee sidelined by nanny-tax violations among other issues, skirting the law prevents you from taking helpful child-care tax deductions. It also poses a real risk of consequences from an Internal Revenue Service audit or future claims by your nanny. And it can rob your nanny of the security of government benefits down the road.

There are many rationalizations for taking the low road. An Atlanta mother, a writer, wanted to compete for good nannies by paying well. If she had cut their take-home pay by withholding taxes, "they could have gone to 20 other homes where they didn't have to pay taxes," she says. Paying more to make up the difference can be a financial hardship. And many nannies are illegal aliens who want to avoid government attention.

The law requires anyone who pays a household employee more than \$1,400 a year to file Social Security and Medicare taxes of 7.65% of the worker's gross pay. Federal unemployment insurance of 0.8%, state unemployment insurance that usually amounts to 2% to 4%, and other state and local taxes also are required. The employee's share is another 7.65% for Social Security and Medicare, plus any state and local taxes. The employer's cost adds up to about 9% to 12% of a nanny's gross pay. If income taxes are withheld, the cost to the nanny is usually about 20%.

If you can't stand paperwork, filing services, such as GTM Household Employment, Clifton Park, N.J.; Breedlove & Associates, Austin, Texas; and HomeWork Solutions, Sterling, Va., cost an additional \$36 to \$55 a month for such services as preparing returns and issuing paychecks.

While the costs add up, evading them prevents parents from taking offsetting tax breaks. A federal dependent-care assistance program allows parents to use as much as \$5,000 in pretax earnings to pay for child care, saving \$1,000 for a family in the 20% tax bracket. Families also may qualify for a tax credit of 20% to 35% of child-care expenses, on an income-based sliding scale. These breaks could make a big dent in nanny taxes. Filing for them, however, requires the nanny's name, address and Social Security number; the form includes a warning of the potential need to file Schedule H.

Dodging the taxes risks other consequences. In an audit, the IRS may notice regular payouts from your account and raise questions about your nanny. While potential consequences include a criminal fine of as much as \$250,000 and jail time, nanny-tax violators typically are required to pay only the back taxes, plus interest and penalties.

The best route is to make payroll taxes a condition of employment. Otherwise, some future claim by your nanny may bring penalties raining down. A California nanny last year filed for state disability benefits after she left her job, and the family had to scramble to get her to withdraw her claim and settle with them privately, says the family's attorney, Bob King of Legally Nanny, Irvine, Calif., a provider of tax and legal help to household employers.

If your nanny has been off the books, it can be tricky to shift to withholding taxes. Some parents fear drawing the IRS's attention by doing this, but Mr. King says he hasn't seen an audit triggered by such a move. "It's best to come clean as soon as possible" to keep back taxes and potential penalties from piling up, he says.

Many nannies need educating about the benefits of building a retirement or disability safety net. When a Boston family began paying payroll taxes on their nanny, they gave her a \$25-a-week raise to blunt the damage to her take-home pay. But the mother, a manager at a software concern, and the father, who is temporarily disabled, couldn't afford to make up the entire difference, and the nanny's paycheck fell to \$361 a week from \$475. Fortunately, the nanny understood the longer-term benefits and has remained loyal, the father says.

Such committed relationships help form the foundation for quality child care, research shows. I can't think of a better way to foster such bonds than ensuring retirement, medical, unemployment and disability benefits.

"I entrust my nanny with my child every day," says Meg Halverson, Seattle, a group program manager for a Web-based retailer, who pays the nanny tax. It pains her and her husband to pay 17% in taxes on top of a \$528-a-week salary, plus benefits. But "the least I can do is try to make sure there will be some sort of Social Security benefit for her."