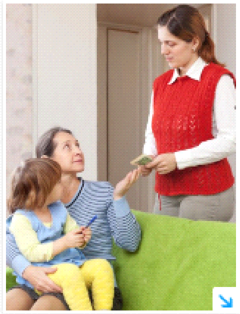
Avoiding nanny tax can come back to cost you more

Jeff Reeves, Special for USA TODAY 7 a.m. EDT April 12, 2014



(Photo: Thinkstock)

Many Americans think having household employees means living the life of Lord Grantham in the PBS hit *Downton Abbey*, with butlers and maids at your beck and call.

But in the eyes of the Internal Revenue Service, if you pay $1,800 or more per year to someone for child care or other in-home services, you're a technically a household employer.

And that means a lot more paperwork come tax time.

"It's not just the rich. The reality is that these are everyday, real families — dual income folks with someone helping out in their home to help take care of their kids," said Stephanie Breedlove, the vice president of Care.com Homepay, a website that helps families manage regulations regarding household employees. "The tax requirements that come with that are commonly overlooked."

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According to the IRS, household employees include nannies, gardeners, housekeepers or other folks who work directly for you.

If you paid $1,800 or more in wages for someone to provide a service like this in tax year 2013, you' officially a household employer. Here's what that means:

• **You must register with the state and the IRS**. You will get an employer identification number, and must identify who is working for you and where the work occurs.

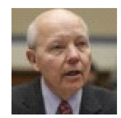
• **You must withhold and remit your employee's taxes.** Just like big businesses, you must withhold Medicare, Social Security and other applicable taxes from household employee wages. And, of course, you have to make sure that money gets to the government.

• **You must pay the employer's portion of any payroll taxes**. All U.S. employers also shoulder their own taxes over and above what's paid by the worker. The typical household employer must pay 6.2% of wages in Social Security tax and 1.45% in Medicare tax out of their own pocket for each employee.

Of course, every situation is different based on wages and local taxes.

There's also some gray area as to who qualifies as a household employee.

TAX NEWS AND ADVICE



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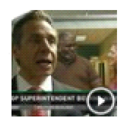

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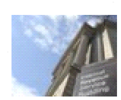

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John Waggoner

For instance, a housekeeper who works for ABC Maid Services and brings their own cleaning supplies to the house wouldn't apply, Breedlove said.

Just remember that someone must pay the tax man — either you, a third-party business or the worker if he or she is an independent contractor.

Tax breaks for household employers

While the prospect of paying extra tax as a household employer isn't fun, the good news is that there are tax breaks to offset some of the costs.

For instance, the most common in-home employee is a nanny or babysitter, says Breedlove. Anyone who pays for child care in any form can claim up to $6,000 in dependent care breaks using the Child and Dependent Care tax credit using Form 2441.

IRS PUBLICATION 503: Child and dependent care expenses

Breedlove also points out that dependent care tax break this covers elder care as well, so long as the person being cared for is reported on your return as a dependent.

"Any kind of elder care, part time or full time, falls under the exact same categorization as a nanny," she said.

There are also other medical and elder care breaks that may be available depending on the level of income for the person being cared for and the type of care that is provided.

As for housework or gardening, however, taxpayers are out of luck.

"There are only tax breaks underneath our tax code for care," Breedlove said.

She also warns that while it's tempting to claim household employees under business expenses if you are self-employed or work out of your home, that can result in a lot of trouble.

"By law, you must always classify anyone who works in your home as a household employee" even if you do legitimate business out of your residence, Breedlove says. "If you were to pay the employee through your business, that is illegal and is considered tax evasion and you're putting your business at risk."

Don't overlook filing as a household employer

If you've been acting as a household employer and haven't been filing the proper paperwork, don't panic.

Start with Publication 926 from the IRS that outlines what your responsibilities are and what forms you need to file, Breedlove says.

And if after review you decide the process is too complicated or time consuming? Then you can always consult a qualified tax professional or seek out services like Care.com Homepay that manage the withholding process for you.

"The complication of the tax law for families who have to comply with household employment law can seem a little daunting and the IRS estimates that it takes about 55 hours a year to manage the process effectively on your own," Breedlove said. "That's why there are services out there to help."

Regardless of whether you manage the process yourself or pay a professional for assistance, it's crucial to be in compliance because it's easier to get caught than you think.

"The main way that families tend to get caught is if their employee leaves their employment and goes to file for unemployment benefits" but obviously there's no record of them working since you didn't report the employee, Breedlove said. "The other is general disputes — overtime disputes, wage disputes, people leaving on bad terms."

And what happens if you do get caught?

"You're responsible for back taxes, penalties and interest. And those are compounding so the penalties can be larger than the taxes themselves," Breedlove said. And while it's rare, "the law also does say that you can be charged for tax evasion which is a felony charge, and you can also be fined up to $250,000."

If you didn't withhold taxes like you should have in tax year 2013, Breedlove says there's still time; Simply pay up and ask the IRS to forgive you for your previous oversight, because the government is typically quite forgiving.

"With a concerted effort of writing letters to explain your situation, that you're a household employer and you have just gotten started and ask would you please waive the penalties, our experience is that more than 95% of the time the state and the IRS do," Breedlove says. "They would rather people be compliant than penalize them."

Jeff Reeves is the editor of InvestorPlace.com and the author of The Frugal Investor's Guide to Finding Great Stocks.