NANNY TAX LEGISLATION: NOT A PRACTICAL SOLUTION

by Richard B. Malamud

Professor Richard B. Malamud teaches federal income taxation at California State University Dominguez Hills.

Malamud believes that the goal of the 1994 nanny tax changes — that of simplifying (and decriminalizing) the payment of household employment taxes — was not accomplished. The article points out that failure to comply with the new employment tax requirements may not subject the employer to tax penalties due to "section 530" relief granted by Congress in 1978 to employers who treat their workers as independent contractors.

The article states several reasons why employers have not paid employment taxes in the past and suggests that compliance may not occur under the new law because (1) it has not created real simplicity and (2) employment tax costs are still too high for many household employers. The article offers a solution: repeal and replace the 1994 legislation with a law that treats household workers as independent contractors for federal and state purposes, subject only to the employer FICA tax withholding of 7.65 percent. This could encourage compliance by reducing employer costs while leaving the employee's income and employment taxes unchanged. It would also have the effect of providing social security and Medicare coverage to hard working, part-time workers, many of whom are denied coverage under the 1994 legislation because they do not receive over $1,000 per year from one employer.

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Problems involving employer responsibility for employment taxes relating to household help (nanny taxes) have involved well-known citizens such as Zoe Baird, Pete Wilson, and Christine Todd Whitman. Prior to the recent changes in the tax law relating to nanny tax reporting, it was estimated that only a quarter of the two million households that employed domestic workers were paying social security taxes.[1] As this article will point out, the 1994 changes may not be as successful as Congress had hoped.

I. Can Section 530 Relief Be Used?

Business employers continue to battle with the IRS over employment taxes, the IRS asserting that some "workers" are employees and the businesses claiming that they are independent contractors, even though Congress took a significant step forward in solving some of these worker classification problems when it passed section 530 of the Revenue Act of 1978.[2] That section provides an affirmative defense to an otherwise valid claim for failure to pay employment taxes based on a consistent misclassification of an employee as an independent contractor.[3] However, even that defense works only if the taxpayer has provided Forms 1099 for all periods, not just the tax year in question.[4] Thus, many business taxpayers who paid over $600 during the year to an arguably independent contractor and are thus liable for filing informational returns[5] may not be able to avail themselves of section 530 relief because of their failure to file those returns.[6]

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[1]Alexandra Alger, "Zoe's Revenge," *Forbes*, Nov. 6, 1995, at 376 (Comments of Fred Goldberg, commissioner of the Internal Revenue Service at the time of the Zoe Baird hearings).

[2]P.L. 95-600, 95th Congress, H.R. 13511.

[3]P.L. 95-600, section 530(a)(1)(B).

[4]*Claire W. Murphy v. U.S.*, 93 *TNT* 234-21, 72 AFTR 2d 93-6693 (WDWI, 1993).

[5]Section 6041(a).

[6]Section 530(a)(1)(B) provides that "in the case of periods after December 31, 1980, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed. . . ."

Can nonbusiness taxpayers avail themselves of section 530 relief? It appears that they can as long as they meet two additional conditions:[7]

> (1) The taxpayer did not previously treat the worker as an employee. That test will almost always be met. It is unlikely that a taxpayer will treat a household worker as an employee one year and then start to treat the same employee as an independent contractor in a subsequent year.[8]
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> (2) The taxpayer must have a reasonable basis for treating the worker as being an independent contractor rather than as an employee. The statute provides that a taxpayer has a reasonable belief for treating the worker as an independent contractor if that classification is a "long-standing recognized practice of a significant segment of the industry in which the individual was engaged."[9] Given the long-standing treatment by such luminaries as the governors of several states as well as a majority of affected taxpayers, the industry consisting of household employers has treated household workers as independent contractors.[10]

Thus, it appears that section 530 operates as an affirmative defense against IRS classification of most household workers as employees prior to the 1994 change in the law.[11] Unfortunately, there do not appear to be any cases in which a nanny tax "employer" has sought relief under section 530.

II. Does the 1994 Legislation Really Help?

Assuming that section 530 does not apply as a defense and that household workers are employees, what is the effect of the passage of the 1994 nanny tax legislation, the Social Security Domestic Employment Reform Act of 1994?[12] That legislation attempted to solve the nanny tax problem by exempting from employment taxes most household help under the age of 18[13] and those employers whose employees earned less than $1,000 per year.[14] Although this successfully exempted some employers, will it solve the problem? Will household employers whose workers earn more than $1,000 per year report those wages to the IRS and pay the required employment taxes? To answer that question, it is important to determine if the nanny tax situation involves an employer problem, an employee problem, or a problem for IRS auditors.

A. Employer Problem

The employer problem (from the IRS point of view) was household employers' failure to pay employment taxes on household workers wages, even though long-standing published rulings have treated most household workers as employees rather than independent contractors.[15] By failing to report wages on household workers, employers are liable for back taxes, penalties, and interest. The employment taxes are equal to 15.3 percent of FICA wages and federal and state unemployment taxes could add another 6.2 percent.[16] Is it any wonder many taxpayers fail to report and pay these taxes?

B. Employee Problem

The household employee's problem involves both a current problem and a future problem that will become apparent only at the time of the employee's retirement. When a household worker's employer fails to report and withhold employment taxes, the employee will probably also fail to report the wages on Form 1040 for the year. Thus, the employee may be liable for income taxes and penalties for failure to file a tax return. In addition, since no wages were reported by the employer (and the worker probably did not report the compensation as self-employment income), social security wages are not credited and it may be difficult to qualify for social security or Medicare benefits at retirement. The change in the threshold for reporting from $50 per quarter to $1,000 per year of wages was, according to the conference report, intended to correct the social security coverage problem.[17]

C. Who Is Responsible?

The responsibility for the failure to report and pay employment taxes is often the result of the employer's desire to save the cost of the employment taxes. Prior to the changes made for 1995, it also resulted from many employers' desire to avoid the complex filing required of quarterly and annual employment tax returns, plus Forms W-2 and related transmittal

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[7]Section 530 should apply to employers of household workers because section 530 applies to taxpayers rather than to employers engaged in a trade or business. Thus, the rules apply to all individuals, not just those engaged in a trade or business.

[8]This test is on an employee-by-employee basis.

[9]Section 530(a)(2)(C).

[10]*See* Dennis R. Lassila, "What Is 'Reasonable Basis' Under the Independent Contractor Safe Haven Rules?" 78 *J. Tax.* 164, March 1993. *Cf.* Rev. Rul. 71-389, 1971-2 C.B. 341, which does not deal with industry standards. It holds that cooks, waiters, butlers, housekeepers, governesses, maids, valets, baby-sitters, janitors, laundresses, furnacemen, caretakers, handymen, gardeners, footmen, grooms, and chauffeurs of automobiles for the family are employees, but that social secretaries and carpenters are independent contractors.

[11]It is unclear what effect, if any, the enactment of the "nanny tax" provisions have on a section 530 defense.

[12]H.R. 4278.

[13]Section 3121(b)(21).

[14]Section 3121(a)(7)(B) raised the filing requirements for cash remuneration paid by an employer to an employee for "domestic service" to $1,000 per year from $50 per quarter.

[15]*See* Rev. Rul. 59-386, 1959-1 C.B. 120 (holding that domestic services of more than $50 per quarter require withholding of employment taxes), and Rev. Rul. 68-398, 1968-2 C.B. 439 (holding that a private attendant is an employee of the patient).

[16]Section 3301.

[17]140 *Cong. Rec.* No 144, Oct. 6, 1994, S. 14396, S. 14397.

forms.[18] However, in many cases, the failure to report household employee compensation results from the employee's desire to avoid income tax when wages (or the family wages in the case of a married worker) exceed the minimum filing requirements.[19] Another reason that a household worker may not want the employer to report wages to the IRS is that the worker may be an undocumented worker. This is a major legal problem both for the worker who might be identified and for the employer who is required to prepare a Form I-9 (Employment Eligibility Verification) for each employee.

D. IRS Problem

As for the Internal Revenue Service (and the federal deficit), the problem is the loss of both employment and income taxes. As discussed above, the loss to the Treasury from the failure to report household compensation may be very large. The Conference Report to H.R. 4278 states that the widespread problem of noncompliance was estimated at over three-quarters of the employers of domestic employees.[20] That amounts to over 1,500,000 taxpayers, most of which the IRS could never efficiently catch.

III. The Congressional Solution

Given all these problems, what solution did Congress come up with? It sought to solve the problems associated with the underreporting of household workers' wages and taxes by increasing the reporting threshold from $50 per quarter to $1,000 per year and simplifying the reporting system from a quarterly to an annual system. According to one expert, this would "greatly improve coverage."[21] And Senator Moynihan stated: " . . . after 44 years, we have *decriminalized baby-sitting*."[emphasis added][22] Thus, Congress passed legislation that it felt fairly dealt with the problems listed above by: (1) simplifying reporting, (2) improving coverage, and (3) "decriminalizing baby-sitting."

Unfortunately, as described below, it is unlikely that the 1994 legislation (effective for tax years beginning in 1995) will have the desired effect.

A. Simplification

In the area of simplification, annual reporting appears to be fairly successful. What could be simpler than annual filing and paying a worker's employment taxes as part of the regular filing of Form 1040? The IRS has published Form 1040, Schedule H for 1995, which greatly simplifies the complexities of the prior law's quarterly and annual filing and payment of FICA and FUTA taxes.[23] Schedule H is a fairly simple two-page form used to report the worker's employment (FICA) and unemployment (FUTA) taxes.[24] Unfortunately, because many household employees are paid in cash, many taxpayers do not have adequate records to prepare even an annual return. In addition, many states have maintained quarterly filing requirements, thus negating much of the advantages of the annual simplified federal tax payments.[25]

Another area of complication involves the ID number to be used in preparing Schedule H. The IRS originally stated that individuals could prepare Schedule H using their individual social security number.[26] Late last year, IRS officials abruptly changed their minds, and stated that household employers must obtain a separate employer ID number.[27] How many household employers have access to a Form SS-4, needed to apply for an employer ID number?[28]

Some of the simplification thus was negated by the IRS and some by the states. Although annual reporting seems to be a form of simplification, Congress still didn't simplify the system enough as many taxpayers and accountants will find out on March 1, 1996. This is because household employers are required to prepare and file W-2s for each employee by the end of February,[29] even though they are not required to file

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[18]In addition to the difficulty of preparing the required tax forms, many household employers are incapable of accurately determining the amount of wages paid to an employee. This is because many taxpayers do not keep track of the number of days that a part-time household worker worked during the year. If he works once a week, did he work 52, 51, 50, or fewer days last year? Did he receive a Christmas bonus, what week did he start, which week did he quit, and when did the pay go up by $5 a day? Most honest taxpayers who pay with cash have no way of accurately determining the amounts paid to a worker at year end.

[19]The filing requirements of $6,400 for single taxpayers and $11,550 for married taxpayers filing a joint return for 1995 are well below the minimum wage for a full-time worker.

[20]140 *Cong. Rec.*, No 144, Oct. 6, 1994, S 14396.

[21]*Id.*, summarizing the testimony of "every witness" and Robert J. Myers, chief actuary of the Social Security Administration.

[22]*Id.*

[23]Taxpayers who previously reported domestic employees received a package from the IRS in January, complete with copies of Schedule H and Form W-2. Unfortunately, those who previously did not file employment tax returns for domestic workers, did not receive the package. They are required to call the IRS or go to a Post Office and obtain Schedule H or ask that they be sent a copy of Publication 926, Household Employer's Tax Guide.

[24]Form 1040, Schedule H is a two-page form. The first page asks three questions regarding filing requirements and then has nine lines for calculating the social security, Medicare, and income taxes. The second page has two parts for calculating the federal unemployment tax, which consists of 18 lines.

[25]Section 3510(f)(1) provides that the Secretary is authorized to enter into agreements with the states to collect the state unemployment taxes for domestic service. If simplification were really desired, rather than being authorized, it would have been mandated.

[26]*See* the instructions to Form SS-4 (1995).

[27]Ann. 95-71, 1995-35 I.R.B. 22.

[28]For household employers who do not, they must call the IRS 800 number and request a Form SS-4, which, if they are lucky enough to get through to the IRS, will state that they do not have to obtain an employer ID number if they are a household employer.

[29]Reg. section 31.6051-1(b)(1). They may also be required to provide Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit. Fortunately, for many taxpayers, this notice is included on the back of Form W-2. But is this requirement a part of the simplification?

Schedule H and pay the employment taxes until April 16, 1996. In fact, they are actually required to mail the W-2 to their employees by the end of January.[30] Every additional form required of the employer negates the idea that the legislation created simplification. Real simplification could have been achieved if the IRS had somehow folded the W-2 filing into Schedule H. By failing to do so, the legislation has not achieved the simplification hoped for by taxpayers and probably even that desired by Congress.

The most far-reaching simplification is the exclusion from employment taxes of baby-sitters under 18, unless that is their primary occupation.[31] The other simplification is that withholding taxes are no longer reportable for household workers who are paid less than $1,000 per year.[32] Unfortunately, even these rules are not simple. The $1,000 per year per worker applies only to employment taxes.[33] The rule for unemployment taxes is $1,000 for any quarter (for the tax year or the previous year) for all household workers as a group.[34] Thus, employers of household workers in 1995 may have to file Schedule H to pay either only employment taxes, only unemployment taxes, or both employment and unemployment taxes, or they may not have to file the form at all, depending on the number of workers, how much they were paid, and when they were paid. Is this simple? No, the recordkeeping is just as difficult as before. At least there is only annual filing, but even that isn't simple.[35]

B. Improved Coverage

The 1994 nanny tax changes may improve the coverage of some household workers, because of the easier annual filing requirement. But, simplification alone may not be enough to turn around millions of nonreporting taxpayers. We live in a society where taxpayers rarely report taxable income that they believe the IRS is incapable of finding. For example, although it is clear that taxpayer's must report all gross winnings from gambling (with an allowable itemized deduction for their losses), taxpayers rarely report their winnings when no Form 1099 was sent to the IRS. The same failure to report exists with respect to the tips earned by waiters and waitresses that exceed those reported on their W-2s. Given this perception, will household employers suddenly become honest and report wages paid to their workers if they believe the IRS is incapable of detecting cash payments to household workers?

Some taxpayers will feel the pressure to voluntarily file Schedule H because they believe that there will be improved IRS scrutiny based on newspaper and magazine publicity of the nanny tax changes. Greater IRS publicity and increased questioning by accountants who find it harder to close their eyes to their client's failure to report the nanny tax[36] may also improve reporting by household employers.

Increased scrutiny by the IRS and by accountants may also have the opposite effect. Some taxpayers may be concerned that if they start reporting household employees in 1995, the IRS will audit them for back taxes, penalties, and interest. Unfortunately, since the IRS has not made any public statements in this regard, taxpayers may be justified in their fears. Other taxpayers may simply not want to pay the additional taxes of up to 20 percent of the compensation paid to their workers. Still others may honestly believe that part-time workers, such as monthly or weekly house cleaners, are independent contractors,[37] regardless of IRS rulings that appear to be to the contrary.[38] Moreover, there is no way the average taxpayer can make an informed decision on the issue of independent contractor vs. employee. Even experienced tax preparers face a difficult task explaining the state of the law on this issue.[39] If a taxpayer determines that a worker is an independent contractor, then the worker will continue to be unreported. This will likely be the case for many household employers.

Another coverage loophole — if the goal is increased coverage of workers — is the legislation itself, which by its own terms has the opposite effect for many part-time employees. It eliminates the reporting and employment tax payment requirements for all employees who are paid less than $1,000 per year by an individual employer and it also exempts this compensation from self-employment earnings.[40] Accordingly, a housekeeper who works once a month for $50 per visit and has 20 employers receives $600 from each employer and total income of $12,000

[30]Section 6051(a).

[31]Section 3121(b)(21). Note that section 3401(a)(3) exempts from wage withholding requirement, remuneration paid "for domestic service in a private home. . . ."

[32]Section 3121(a)(7)(B).

[33]Section 3121(a)(7)(c).

[34]Section 3306(c)(2). It is also not clear to this writer (although most articles assume this to be the case) that the baby-sitter exception applies to FUTA taxes. But who has the energy to go through the code that carefully? The point is that if an experienced tax professional cannot find the operative FUTA exception for baby-sitters, can the normal taxpayer who has no access to the code?

[35]*See, e.g.*, Albert B. Crenshaw, "Simplified Nanny Tax Rules Can Still Create Headaches," *Washington Post*, Dec. 10, 1995, H-1.

[36]*Id.* stating: "tax preparers, who are under increasing pressure to verify the information they get from taxpayers, are concerned that they might be held accountable if a client doesn't tell them about a nanny."

[37]*But see* Rev. Rul. 87-41, 1987-1 C.B. 296, *87 TNT 100-1*, indicating that there is no difference for employment tax classification purposes if a worker is full or part time.

[38]For example, the IRS has ruled that a bona fide employer-employee relationship exists where a brother hires a sister (typical 1950s sexism) to act as a housekeeper. Rev. Rul. 54-572, 1954-2 C.B. 341. *See also* Treas. reg. sections 31.3121(a), 31.3306(c), and 31.3401(a) relating to which domestic service providers are employees.

[39]To do so, they would presumably have to understand the FICA, FUTA, and wage withholding rules. They would also have to understand the 20-factor formula of Rev. Rul. 87-41, 1987 1 C.B. 296, and they would have to be able to reconcile seemingly irreconcilable rulings such as why under Rev. Rul. 77-279, 1977-2 C.B. 33, if you drop your kids off at someone's house, that person is an independent contractor, but if the same person, with the same responsibility and guidance, comes to your house, she is an employee under LTR 8822077, *88 TNT 119-139*, and various other rulings.

[40]In fact, section 1402(c)(2) also eliminates these employees from self-employment tax. The net effect is to deny these daily workers social security benefits.

per year. The legislation, by exempting these part-time employees from coverage, guarantees that none of the employers will report the wages and thus that the employee will not be covered by social security. In addition, the workers will probably feel safer than ever in failing to report taxable income, resulting in a loss to the Treasury of approximately $2,400 in employment and income taxes per worker.[41]

In short, it is not clear either that simplification has been achieved or that if it has, that it will result in a large increase in household worker reporting. Moreover, in the case of part-time employees, simplification will result in less reporting, thus hurting those employees by denying them coverage under social security or Medicare.

C. Decriminalization

The nanny tax legislation has decriminalized the failure to report household workers, but only for those employers who pay a worker less than $1,000 per year. Nothing was changed for those who pay more than $1,000 per year, except that they can report and pay the taxes annually instead of quarterly. Household employers who previously failed to report that they hire workers must either come forward and report the wages and pay the employment taxes or continue to be "criminals." It is interesting that in the past, no one has gone to jail for failure to pay employment taxes with respect to their household help. At worst, they suffered in the polls or in front of congressional committees charged with approving their nominations for a federal job. Nothing in the 1994 legislation will change that. The only real effect was to make honest citizens of those taxpayers who pay less than $1,000 per year to household help or who hire baby-sitters under the age of 18. For those with full-time help, the legislation was of little assistance, since the annual reporting scheme provides little new incentive to an employer to begin reporting wages and paying taxes on domestic workers.

IV. Solution

The 1994 nanny tax legislation had the right idea, but did not go far enough. Congress was correct in stating that simplicity is important, but so is cost. The difficulty and accuracy of record keeping, the cost of compliance, and the cost to the employer of employment and unemployment taxes are considered by taxpayers when deciding whether to comply with the nanny tax provisions. These costs usually exceed 15.3 percent of wages paid to household workers and that amount probably scares off many otherwise honest taxpayers. The easiest way to increase compliance is therefore to reduce the cost of each to the employer.

Greater compliance can be achieved by treating all household workers as independent contractors for all state and federal tax purposes and requiring all employers of household help, except baby-sitters under 18, to report all household remuneration on a simple schedule, listing only names, addresses, social security numbers, and amounts paid to each worker.[42] Employers should be required to withhold only the employer's share of the employment taxes. This would reduce the cost to the employer to 7.65 percent of wages.[43] As independent contractors, workers would be responsible for their own income taxes and self-employment taxes, but would receive a credit for one-half of the tax, the amount paid by the employer. In addition, since many household employers are likely to file a simple one-page federal form with their federal payments of 7.65 percent, the IRS would have a record of many new household workers that they could then determine worker tax compliance for income and self-employment taxes. If household workers desire coverage under the unemployment or state disability acts, they should be provided with optional (elective) coverage by filing a simple one-page form for paying those taxes.

V. Conclusion

In many ways, the Social Security Domestic Employment Reform Act of 1994 resembles the changes made by the Emergency Unemployment Compensation Act of 1991, relating to the changes in the estimated tax provisions.[44] The changes may have been theoretically correct, but were overly complex, hard to apply, and applicable only to some taxpayers. Just like those provisions, which were repealed and replaced with a less complex law, the nanny tax should be repealed and replaced by a simpler, less expensive, and easier to follow law, if there is any hope for full compliance.

Only time will tell if compliance with the nanny tax will increase due to the 1994 changes in the law. The IRS can have a substantial impact on the compliance rate, especially if it publicizes the number of taxpayers who file Schedule H for 1995 and audits those who don't. However, if the nanny tax changes were not successful in convincing household employers to withhold, it is unlikely that the IRS can solve the reporting problem by auditing those taxpayers. In 1994, such an undertaking would have required audits of at least 1,500,000 returns. That is more individual returns than the IRS audited in 1994.[45] Thus, unless the changes made by the Social Security Domestic Employment Reform Act of 1994 are voluntarily complied with by most household employers, the better solution is to change the law and to totally decriminalize the hiring of household workers by making them statutory independent contractors.

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[41]This is based on a single taxpayer earning self-employment income of $12,000, which results in income taxes of $713 and self-employment taxes of $1,696. Even those honest taxpayer-employers may be willing to underreport wages, thus saving the employee income taxes and the employer employment taxes.

[42]Small payments, such as $400 per year (the minimum self-employment filing standard) could be excluded from reporting requirements.

[43]Some employers may argue that even this amount is too much, but it seems like a fair compromise.

[44]*See* Richard B. Malamud, "Accelerated Estimated Taxes, a New System for 1992," 15 *L.A. Lawyer* 11 (1992).

[45]In fact, only 1,225,707 individual returns were audited in 1994. *See RIA 1996 Federal Tax Handbook*, section 4804.