

# The Legal Review

Sharing Case Law that Affects the Household Employment Industry

A Complimentary Resource from  
**Breedlove & Associates**

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*In an effort to help you strengthen your business practices and steer clear of legal trouble, The Legal Review will share findings from relevant legal cases. We've found that the easiest way to gain a practical understanding of complex tax and labor law is by reviewing real-life situations. These stories will illuminate potential legal landmines for your agency and/or your clients, and more importantly, show you how to avoid them.*

## **Negotiating Salary Based on Net Wages vs. Gross Wages: Nanny vs. Family**

### **The Mistake**

A family negotiated and agreed to salary on a NET basis. The family verbally agreed to pay all federal and state employee payroll taxes *on top* of the net salary.

### **The Law**

Why is this a problem? There is no method provided by the IRS or any state for adding payroll taxes *on top* of net salary. It is assumed that salaries are agreed upon based on gross wages, and all payroll taxes are withheld *from* the gross salary. All tax withholding forms and reports, such as Form W-4, Form W-2, and quarterly tax reports to the IRS and state assume that taxes are withheld from gross salary. This logic governs the payroll and tax process and assumes that payroll taxes are calculated based on gross wages and the number of allowances provided by the employee on Form W-4. The tax tables provided for income tax withholding are not exact, and any refund or payment of income taxes at year-end is assumed to be the exclusive responsibility of the employee. Employers are required to do their job throughout the year by withholding, reporting and remitting taxes. Employees are responsible for the over or under withholding of income taxes at "tax time." Most importantly, the law assumes that an employer is never financially impacted by employee payroll taxes, as they are withheld from gross salary not added to net salary.

As you can see, trying to maneuver and manipulate the tax calculation, reporting and payment process to fit a salary negotiated on a net basis is usually a formula for disaster.

### **The Mess**

- Employment began in the month of April. The nanny was paid the agreed-upon net salary each pay period, but the family did nothing to be in compliance with the law. The nanny assumed that payroll taxes were being paid for her over and above her net salary.
- In January, 9 months later, the nanny requested Form W-2 to file her federal and state income tax returns. The family could not provide Form W-2. The family began the compliance process at this time and hired Breedlove & Associates to report and remit payroll taxes for the previous 9 months and to continue with timely compliance into the future.
- Upon review of the expense to add the nanny's taxes on top of her net salary, the family experienced significant "sticker shock." This was not an expense they had planned for, although they knew they had agreed to it. In an attempt to decrease this expense, the family chose to add only social security and Medicare taxes on top of the net salary. They left the payment of federal, state and local income taxes to the nanny. Although not recommended, this is allowed by law.

### **The Mess (continued)**

- Form W-2 was provided to the nanny documenting wages and taxes paid. The nanny prepared her annual federal and state income tax returns in March and learned that she had an \$11,000 income tax bill.
- The nanny hired a lawyer and threatened to sue the family, because they did not fulfill their verbal agreement to add ALL employee payroll taxes on top of the net salary (social security, Medicare, federal, state and local income taxes).
- The family retained a lawyer, arguing that they were in compliance with the law and that covering ALL employee payroll taxes produced a total household employment budget that was excessive for today's marketplace.
- The family contacted the agency that placed the nanny to include them in the blame. The family contended that the relationship was a failure, because it had become much more expensive than anticipated. They would not have agreed to such a high net salary had they understood how expensive it was to cover the nanny's taxes.

### **The Outcome**

- Breedlove & Associates, along with the family's lawyer, recommended that the family pay the nanny's federal, state and local income taxes. Although not required by law, this was agreed upon verbally. In addition, we felt it would be less expensive and less time-consuming than a law suit.
- The family accepted the recommendation. The employment relationship terminated. The family hired a new employee through a *different* placement agency. The family negotiated the new salary on a gross basis. The agency avoided involvement in a law suit.

### **How the Whole Thing Could Have Been Avoided**

- The agency owner stated: "This should be a standard part of our process, and I don't know why we let ourselves believe we can skip it."
- Including education on legal requirements and budgeting as a *standard* part of the placement process will prevent families from agreeing to cover payroll taxes out of ignorance. Those that still choose to negotiate salary on a net basis will do so knowing the potential pitfalls and risks.
- Allowing clients and candidates to negotiate salary based on NET makes it that much more difficult to understand the tax requirements and how to budget. In addition, it decreases the probability that they will pay and be paid professionally.

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