

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.

Nanny vs. Family Business: The IRS Requires Household Employers to Pay Personal Employees Out of Their Personal Finances

The Mistake

A family paid their nanny as an employee of their family business. The nanny's payroll taxes were withheld and remitted to their state and the IRS for their nanny as a part of the **company** payroll and tax process.

The Law

Why is this a problem? Businesses are allowed to take tax deductions on their company payroll. The IRS logic is that employees are direct contributors to the success of the business and, therefore, the business entity is allowed to take advantage of a "tax break" on a portion of the company payroll to help offset some of this investment. To be legally deductible, employee compensation must be an ordinary and necessary expense of the business.

The IRS has ruled that a household employee is a contributing member of the household — not the business. Therefore, it is illegal for the business to take any deductions on her payroll. Instead, the payroll must be treated as a household expense and paid for by the household via a personal bank account.

Please note that while the business is not able to take advantage of **business tax breaks** on the nanny's payroll, the household employer is entitled to **childcare tax breaks** on their personal income tax return.

The Mess

- The nanny terminated employment and was very disgruntled. She made financial demands for: additional pay for stressful working conditions, pay for vacation not taken, and compensation for additional duties not initially defined.
- The family offered \$2,000 in an attempt to satisfy her demands.
- The nanny rejected the offer, retained a lawyer after learning that she was paid as an employee of the family business, and brought a suit against the business for a large sum of money.
- The family hired a lawyer to fight the lawsuit. Months of fact-finding, legal research, interviews, and depositions in preparation for a trial followed.

The Outcome

- The case was settled out-of-court for approximately \$20,000. Why did the family settle? Paying the nanny as an employee of the business — rather than as an employee of the household — subjected the business to possible damages that represented more risk than the business was willing to take. The family's lawyer felt that a jury might focus on the family's ethics and potentially award a large sum of money, given that the nanny's payroll was recognized illegally as a business expense rather than a household expense.
- The family business eliminated the nanny's payroll and taxes from its records and amended its tax returns. The family contracted services from Breedlove & Associates to open tax accounts as a household employer and report wages and file taxes to the state and IRS as a household employer for the duration of the nanny's employment.
- The family chose not to hire another nanny.
- The agencies in the area were relieved that the family did not hire their nanny through an agency.

How The Whole Thing Could Have Been Avoided

The family should have established themselves as household employers with the IRS and state, remitting all wage information and employment taxes separately from the family business. Legal action may not have been avoidable; however, a lawsuit against a household employer carries significantly less risk than a lawsuit against the family business. A household employment dispute would have been handled in small claims court rather than with a jury trial.

If one of your clients is considering placing their new household employee on their company payroll, please advise them of the law and urge them to reconsider. Although it may seem like a convenient way to comply with payroll and tax requirements – and possibly even offer company benefits – it is important for your clients to know that this practice is illegal and it exposes their business and personal assets to unnecessary legal and financial risk.

To help you explain this part of the tax law to your clients, we have developed a one-page educational flyer entitled “Payroll Administration: Home & Business Payroll Must Be Separate.” If you would like hard copies or a PDF version of this flyer, just send an email to info@breedlove-online.com.

If you have additional questions, please call 888-BREEDLOVE (273-3356) or visit www.breedlove-online.com. We're here to help our agency partners provide their candidates and clients with information, tools and resources that improve the employment relationship, eliminate legal risk for all parties, and increase the professionalism of the industry.

