

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.

Reporting Partial Wages: State of California & IRS vs. Family and Nanny

A fairly common myth exists in the household employment industry: it is acceptable to report some of an employee's wages "on the books" and some "off the books." The rationalization is that both family and employee save some tax dollars and the nanny receives some of her benefits. Additionally, because both parties file tax returns and appear to be compliant, they convince themselves they'll fly under the audit radar.

While it's true that your clients and candidates are better off reporting partial wages versus none at all, both parties need to know there is still financial and legal risk. To the state and federal tax authorities, this practice represents a textbook case of conspiring to commit felony tax fraud and tax evasion. Therefore, for your agency's protection, make sure you and your counselors avoid any communication – explicit or implicit – that might be construed as condoning or supporting the practice of reporting partial wages. This case illustrates the risk for clients, candidates and agencies.

The Mistake

When making an offer to a candidate, a family offered to report only half the wages in order to meet a desired "take-home pay." The employment agreement was finalized (and placement fees were calculated) based on a \$30,000 annual salary, but the family and nanny agreed to set up payroll to reflect a salary of \$15,000. The agency counselor, knowing the deal was improper but understandably eager to make the placement work, silently oversaw the negotiations. By failing to raise a red flag, the agency provided implicit approval of the arrangement.

The Law

Employers are required by law to report all compensation paid to an employee. This includes regular wages as well as all cash allowances, overtime pay, bonuses, commissions, gratuities, etc. (The only non-taxable forms of compensation are employer-paid health insurance premiums and employer-paid tuition for an accredited college or university). Verbal or written agreements to compensate an employee completely or partially "off the books" is considered felony tax evasion, punishable by up to 5 years in prison and fines up to \$250,000.

The Mess

After a couple of years on the job, the nanny became pregnant. For health reasons, she was put on bed rest a month prior to her due date. Following the birth, she planned on a two-month maternity leave. Knowing she would need financial help in order to pay her bills during this 3-month period without employment, the nanny called the state's disability benefits office to consult with a case worker about the application process, the amount she could expect, how long before she got a check, etc.

After talking to the case worker, the nanny was upset about what she considered to be an inadequate amount of financial assistance. (All government benefits – including disability, unemployment, retirement, medicare, etc. – are tied directly to reported compensation. Since she had reported only half of her wages, she was due to receive only half of her benefits).

The Mess (Cont.)

Frightened that she would be unable to make ends meet during such a critical time in her life, the nanny desperately pleaded with the family to pay for the other half of her disability benefits. The family told her they would not be able to help her, claiming they would need all their money to pay for a replacement nanny during her time off. Stressed, tired and emotional – and out of options for supplemental income – the nanny decided to apply for her disability benefits with a stated income of \$30,000. This triggered the following series of events:

- The case worker at the state reviewed all the tax records and noticed a discrepancy between the stated and reported wages. The case worker then sent a notice to the employer to verify actual wages.
- The family was now trapped in a no-win situation. If they chose to lie and maintain that the wages were \$15,000, the state would likely audit the nanny and the family, ultimately discovering the conspiracy to evade taxes. If they decided to honestly admit under-reporting of wages, they would be subject to expensive back taxes, penalties and interest.
- Upon learning the consequences of felony tax evasion charges, the family opted to come clean.

The Outcome

- The family was forced to go back to the beginning of the relationship and amend every quarterly state tax return using the corrected gross income of \$30,000. In addition to paying taxes on the unreported wages, the family was also required to pay penalties and interest.
- The family also had to amend two years of personal income tax returns and pay all the social security, medicare and federal unemployment taxes. Because they did not withhold the employee's portion of the social security and medicare taxes on the unreported wages, the family was forced to pay both the employer and employee portions of these taxes. They were also subject to underpayment penalties on these federal taxes, which added two years of interest charges onto the bill.
- The employee was forced to amend her personal income tax returns to correctly report the total compensation. This resulted in additional income taxes and interest on the unreported income. She ultimately got the disability benefits she needed, but she had to set up a payment plan with the tax agencies to cover her increased income tax liability.
- The family contacted the agency repeatedly through this process, threatening to sue for a refund of fees and half the damages. Although they knew in their heart that the partial reporting deal they struck was improper, they claimed that the agency gave them a false sense of security. In their mind, the agency was complicit because they knowingly brokered an illegal placement. The agency ultimately acquiesced to the family's demand in order to avoid the cost and risk of a lawsuit.

How the Whole Thing Could Have Been Avoided

This situation *might* have been avoided if the agency had 1) explicitly warned the family of their obligations to report all wages, and 2) clearly explained to the candidate the benefits available to those who are paid legally and the risk involved in failing to report income.

A thorough understanding by both parties of the taxes, the benefits and the risks would have helped them make an informed decision. Of course, the family and nanny might have decided to continue down the illegal path anyway, but at least they would have done so knowingly – thereby absolving the agency of all risk.

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.



Tax & Payroll Services for Household Employers