

The Legal Review

Sharing Case Law that Affects the Household Employment Industry

A Complimentary Resource from
Breedlove & Associates

© 2007-2008 Breedlove & Associates, L.P.

This is our thirteenth installment of The Legal Review. In an effort to help our agency partners strengthen their business practices and steer clear of legal trouble, we 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.

Family vs. Nanny

How a Match Made in Heaven Went to Hell in a Handbasket

The Mistake

A Texas family hired a nanny through a professional placement agency. They were very pleased with her credentials, experience and fit with their family. They were equally pleased with the high-quality, comprehensive service provided by the agency. They even joined our service – making sure that their payroll and tax reporting was handled professionally.

So what went wrong? The family based the compensation agreement on the nanny's desired net ("take-home") wages. This relatively simple – and very common – mistake boxed them into a situation in which they were forced to "take care of their nanny's payroll taxes" over and above the net wages. Unfortunately, it eventually led to misunderstanding, resentment and irreconcilable differences.

The Law

Why is an agreement based on net wages problematic? There is no provision in payroll and tax law for compensation that is negotiated on a net (after tax) wage since all tax calculations must be based on gross (before tax) earnings. Payroll and tax law specifically mandates the following:

- Employee taxes (i.e. social security, medicare, income tax and potentially other state taxes) are calculated based on gross wages - using the employee's chosen withholding status provided on Form W-4. These taxes are withheld from the employee's gross wages;
- The employee's tax withholdings have no impact an employer's payroll expense since they are withheld from the agreed-upon gross pay;

The intention of the Form W-4 withholding status (i.e. Single / 2 allowances) is to help taxpayers estimate their year-end tax liability so they can "pre-pay" income taxes throughout the year at a rate that approximately covers that liability. However, it's an estimation process - not an exact science - and there are dozens of other non-employment-related factors in an individual's personal tax situation that can affect their tax liability. Therefore, the goal of Form W-4 is to produce a tax refund or payment that is as small as possible. The withholding rate - and therefore any resulting refund or payment - is the sole responsibility of the employee.

Because of this estimation process and the other factors affecting tax liability, it is impossible to "gross up" net wages with precision. There will always be an underpayment or overpayment. And here's where the situation frequently gets contentious: If there is an overpayment, who gets the refund? If there is an underpayment, who owes the remaining balance?

The Events

- The relationship between family and nanny was as good as it gets for over a year. The family was pleased with performance, and the nanny was pleased with her responsibilities.
- The financial agreement also felt satisfactory to all parties. The nanny received her desired and agreed-upon take-home pay. Her paystub showed Social Security, Medicare and Federal Income Taxes totaling approximately 20% above the net wages that comprised the gross wage, and her employer remitted these taxes on her behalf each quarter to the IRS (no state income taxes in Texas).

The Events (Cont.)

- The nanny prepared and filed her federal income tax return (Form 1040) in April and did not owe any taxes. In fact, the nanny learned that she would receive a \$2,500 tax refund. (Important Note: this refund was generated by an overly conservative withholding status provided by the nanny on Form W-4; legally, the decision on withholding status belongs solely to the employee since employee taxes are not supposed to affect the employer). The nanny chose not to disclose the refund to her employer – the first sign of trouble.
- In June, the nanny received the \$2,500 refund from the IRS, and it slipped out in conversation with her employer.
- **The employer's point-of-view:** *I'm entitled to the \$2500 refund! Per the financial agreement, we agreed to cover her taxes – in order to "make her whole." We did not agree to overpay federal income taxes so she could have the equivalent of a \$2,500 bonus.*
- **The nanny's point-of-view:** *I'm entitled to the \$2500 refund! The check from the IRS has my name on it and the refund resulted from my personal income tax filing.*
- The complexities of compensation based on net wages had officially created a very high level of confusion and frustration. To gain a full understanding of the situation at hand, the employer contacted Breedlove & Associates. We explained that *per the agreement*, the family was entitled to the \$2,500 overpayment in taxes. However, *per the law*, payroll taxes are assumed to be withheld from (not added to) the agreed-upon wages. Thus, any overpayment or underpayment of income taxes is the sole responsibility of the employee. Resolution must be reached between the two parties, as there is no law granting the employer rights to the overpayment of federal income taxes. We offered to have the same conversation with the nanny to provide a full understanding to both parties.
- The employee took us up on our offer and contacted us for a complete explanation. At the end of the consultation, her response was: "The check has **my** name on it. H&R Block said it's **my** refund. I need this money and I'm keeping it."

The Outcome

The employer took our advice and renegotiated the salary based on gross wages to eliminate financial liability in the future, but the relationship was damaged beyond repair. The employer felt very misinformed and was having great difficulty recovering from the \$2,500 mistake. She was frustrated with everyone involved – the placement agency, the nanny, the nanny's tax preparer and Breedlove & Associates. Within two months, the relationship terminated.

How the Whole Thing Could Have Been Avoided

We understand that it is very common in our industry to discuss compensation on a net basis. We also know first-hand that finalizing the agreement using net figures is financially de-stabilizing for all parties involved – employer, employee and agency. In this case – which had all the makings of a long-lasting and mutually-beneficial relationship – the damage was significant: 1) a \$2,500 expense to the family in the form of an unintended and unexpected tax refund to their nanny; 2) a lost job for the nanny; 3) a lost client for the agency (not only did the agency lose out on repeat business from this family, it also suffered from negative word-of-mouth as the husband and wife told numerous friends and co-workers about the experience).

The good news is it's easy to avoid this type of situation. Converting the "net discussion" into a "gross agreement" is quick and painless and can be easily handled during the placement process. We make our tools and experts available to agencies and families free of charge for precisely this reason. Just give us a call. We're here to help.

For more information about household employment tax and labor law, please visit us at www.breedlove-online.com or call us at 888-BREEDLOVE (273-3356). 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 risks for all parties, and generally increase the professionalism of the industry.



Tax & Payroll Services for Household Employers