

Abstract: Millions of American families hire people to work in their homes, such as nannies, housekeepers, cooks, gardeners and health care workers. Taxpayers who employ domestic workers need to understand the tax rules — it can pay off for them and their employees. This article discusses household employee qualifications and employee responsibilities, including the tax bite.

Don't make a tax mess when paying household employees

Millions of American families hire people to work in their homes, such as nannies, housekeepers, cooks, gardeners and health care workers. If you employ domestic workers, be sure you understand the tax rules — it can pay off for you and your employees.

Household employee qualifications

Not everyone who works at your home is considered a household employee for tax purposes. To understand your obligations, determine whether your workers are employees or independent contractors. Independent contractors are responsible for their own employment taxes, while household employers and employees share the responsibility.

Workers are generally considered employees if you control what they do *and* how they do it. It makes no difference whether you employ them full time or part time, or pay them a salary or an hourly wage.

Let's say, for example, you hire a nanny to care for your child and do light housework 30 hours a week. She performs her duties according to your instructions and uses your supplies. The nanny is considered a household employee.

On the other hand, suppose you hire a gardener to mow your lawn and provide other landscaping services twice a month. Because he furnishes his own equipment and supplies, pays other workers as needed, sets his own schedule and offers his services to others, the gardener is classified as an independent contractor.

Social Security and Medicare taxes

If a household worker's cash wages exceed the domestic employee coverage threshold of \$1,700 in 2010, you must pay Social Security and Medicare taxes — 15.3% of cash wages, which you can pay entirely or split with the worker. (If you and the worker share the expense, you must withhold his or her share.)

But don't count wages you pay to:

- Your spouse,
- Your children under age 21,

- Your parents (with some exceptions), and
- Household workers under age 18 (unless working for you is their principal occupation).

The domestic employee coverage threshold is adjusted annually for inflation, and there's a wage limit on Social Security tax (\$106,800 for 2010, adjusted annually for inflation).

Social Security and Medicare taxes apply only to cash wages, which don't include the value of food, clothing, lodging and other noncash benefits you provide to household employees. You can also exclude reimbursements to employees for certain parking or commuting costs. One way to provide a valuable benefit to household workers while minimizing employment taxes is to provide them with health insurance.

Unemployment and federal income taxes

If you pay total cash wages to household employees of \$1,000 or more in any calendar quarter in the current or preceding calendar year, you must pay federal unemployment tax (FUTA). Wages you pay to your spouse, children under age 21 and parents are excluded.

The tax is 6.2% of each household employee's cash wages up to \$7,000 per year. You may also owe state unemployment contributions, but you're entitled to a FUTA credit for those contributions, up to 5.4% of wages.

You don't have to withhold federal income tax — or, usually, state income tax — unless the worker requests it and you agree. In these instances, you must withhold federal income taxes on both cash and noncash wages, except for meals you provide employees for your convenience, lodging you provide in your home for your convenience and as a condition of employment, and certain reimbursed commuting and parking costs (including transit passes, tokens, fare cards, qualifying vanpool transportation and qualified parking at or near the workplace).

Tax payment

You can pay federal employment taxes, including amounts withheld from employees' wages, by filing Schedule H, *Household Employment Taxes*, with your Form 1040. You may also submit payroll tax forms for your workers (Form 941).

Although you're not required to make quarterly deposits, you may face penalties unless you cover these amounts. You can do so by making estimated tax payments or increasing withholding from your own paychecks.

If you own a sole proprietorship, you can piggyback household employment taxes onto the deposits or payments you make for your business employees.

Other obligations

As an employer, you have a variety of tax and other legal obligations. This includes obtaining a federal Employer Identification Number (EIN) and having each household employee complete Forms W-4 and I-9, which document that they're eligible to work in the United States.

After year end, you must also file Form W-2 for each household employee to whom you paid more than \$1,700 in Social Security and Medicare wages or for whom you withheld federal income tax. And you must comply with federal and state minimum wage and overtime requirements.

In some states, you may also have to provide workers' compensation or disability coverage and fulfill other tax, insurance and reporting requirements.

A time saver

Running a household is a lot like running a business. Many companies outsource their tax and other administrative functions so they can concentrate on their core business activities. Similarly, if you have household employees, getting help with your tax responsibilities frees up your time to focus on the things that really matter, such as your loved ones and your work.

Sidebar: A spoonful of compliance ...

With many tax and administrative headaches, it's not surprising that people often pay their household employees "under the table." But compliance isn't just the right thing to do; it also offers a number of advantages for both employers and workers.

For starters, you avoid huge penalties and interest — not to mention potential negative publicity. Plus, you may qualify for tax breaks such as flexible spending account reimbursements for child care and the Child and Dependent Care credits. In some cases, these tax savings outweigh the additional tax liability of employment taxes.

Meanwhile, your workers are building an employment history, which helps them qualify for car loans, mortgages and other types of credit. They also benefit from unemployment insurance coverage, Social Security and Medicare benefits, and the Earned Income Tax credit (if eligible).