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HOUSEHOLD EMPLOYEES ---- **A Special Payroll Tax & Reporting Challenge**

Regardless of the serious efforts made to simplify the Federal employment tax rules applicable to household employees, compliance is not a simple matter. And, if one employs a household worker, the employer also may be required to pay or withhold STATE employment taxes.

There are two requirements to qualify as a household employee: a.) the person must be paid to do "household" work, and b.) the worker must be an "employee."

"Household" work is performed in or around a home. However, not all "household" workers are employees. The test is whether the employer can control not only WHAT work is done, but HOW it is done. If the worker thus qualifies as an employee, that status does not change if full-time work becomes part-time. Likewise, pay frequency does not matter --- the worker remains an employee whether paid on an hourly, daily or weekly basis, or by the job. Examples of household employees include maids, private nurses, nannies, health aides, caretakers and yard workers.

Social Security, Medicare and FUTA Taxes

Beginning with the first cash wages an employee earns, generally Social Security and Medicare taxes will apply, although for Social Security the taxable wage limit is \$94,200 in 2006.

However, in 1994 Congress re-defined the household employee's liability threshold for Social Security and Medicare taxes by increasing it from \$50 per calendar quarter, to \$1,000 per year. Then, Congress provided for inflation-indexing of the threshold amount, so that for year 2006 the threshold has become \$1,500 (increased from \$1,400 in 2005). Once a household employee earns that amount from the respective employer, all the CASH wages (including the first \$1,500) are subject to Social Security and Medicare taxes (a 7.65% contribution by the employee, matched by the employer). However, the employer may choose to pay the employee's share without withholding for it. In that case, the employee's tax share *paid by the employer* must be included in the employee's total wage amount for income tax purposes. Note that such employer tax payments are not counted as Social Security and Medicare wages, nor as Federal unemployment (FUTA) tax wages.

In addition, Congress has exempted from Social Security and Medicare taxes the wages earned in household employment by workers under the age of 18. The exemption applies regardless of how much they earn, UNLESS household employment is the worker's principal occupation. For example, a 17-year-old high school student employed by an invalid for two hours of light housework every afternoon, would be exempt from Social Security and Medicare taxes.

In addition, Social Security and Medicare taxes do not apply to wages paid to a household employee who is the spouse of the employer, the employer's child under age 21, or the employer's parent (with exceptions).

Social Security and Medicare taxes apply only to CASH wages. The latter does not include the value of food, lodging, clothing and other non-cash items given by the employer to the household employee. Also, if the employer reimburses the employee for the cost of commuting to or from home by public transit, the reimbursement (up to \$105 per month) is not wages.

The Federal unemployment (FUTA) tax is 6.2% of the household employee's FUTA wages. Generally, it would be

reduced to 0.8% by the credit of state unemployment insurance contributions paid by the employer. However, that requires the FUTA wages paid to be not more than the wages that are subject to state unemployment tax, and the employer must pay all the required contributions for year 2006 to the respective state unemployment fund by April 15, 2007. Importantly, the FUTA tax is not withheld from the employee's wages --- the employer must pay it from his or her own funds.

If the employer pays cash wages to ALL household employees totaling \$1,000 or more in any calendar quarter in 2005 or 2006, the first \$7,000 of cash wages paid to each such employee is FUTA wages. Not counted as FUTA wages are cash payments to the employer's spouse, employer's child under the age of 21, or to the employer's parent.

Tax Deposits and Reporting

The employer is NOT REQUIRED to withhold Federal income tax from wages paid to a household employee. The employer should do so only if the household employee ASKS for the withholding and the employer AGREES. To request withholding, the employee must give the employer a completed Form W-4, *Employee's Withholding Allowance Certificate*.

If Federal income tax is agreed to be withheld, it is figured on both cash payments and the value of non-cash payments. Not taxable is the value of meals and/or lodging provided in the employer's home for the employer's convenience, and as a condition of employment. Also not taxable (in 2006) is up to \$105 per month in reimbursed commuting expenses if the employee uses public transportation, and up to \$205 per month for reimbursed employee parking costs. If the employer chooses to pay the employee's Federal income tax, this amount must be included in the employee's taxable wages for purposes of Federal income tax withholding, Social Security/ Medicare and FUTA taxes.

In 1994, in an attempt to simplify the payroll tax reporting related to household employees, Congress eliminated Form 942, *Employer's Quarterly Tax Return for Household Employees*. A new reporting form was devised (to be used as an attachment to the employer's Form 1040, *U.S. Individual Income Tax Return*). The IRS calls it "Schedule H." Therefore, a household employer can now calculate the payroll tax liabilities (Federal income tax withholding, Social Security, Medicare and FUTA taxes) once a year and pay annually (by April 15 of the following year), instead of quarterly in the current year. By using Schedule H, the household employer is not required to file Form 941, *Employer's Quarterly Federal Tax Return*, OR Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. Schedule H is a complete substitute for the discontinued Form 942.

However, as is true for any other individual taxpayers, at least 90% of the employer's TOTAL personal income tax and employment tax liabilities must be pre-paid by the end of the calendar year. Household employers may complete their OWN Forms W-4, to provide additional Federal income tax withholding at their own place of work, or they may increase their quarterly estimated tax deposits, to cover these tax pre-payments. Note also that even if the only employee is a part-time nanny (or other part-time household employee) the employer must have and use an Employer Identification Number (EIN). An EIN can be obtained by submitting Form SS-4, *Application for Employer Identification Number*, to the IRS.

Importantly, beginning in 1998, the aggregate tax deposits of a household employer (from either the withholding on the employer's OWN wages or quarterly estimated tax deposits) must be sufficient to cover the entire liability arising from being a

household employer, or an estimated tax deficiency penalty may be assessed. Household employers are not required to deposit during the year, other than to meet the normal 90% requirement.

A special payment and reporting rule applies to a sole-proprietor employer (other than a farm owner) who also pays employment taxes for ordinary business employees. For example, suppose a dentist employs a dental assistant in his office. If the dentist then hires a nanny to care for his children, the dentist may choose one of two ways to pay employment taxes for the household employee (nanny): a.) pay the taxes using Schedule H as described above; or b.) include the household employee taxes with deposits and other payments of taxes made for the business employees (i.e., with Form 8109). If the latter option is chosen, the "nanny" reporting should be made on Forms 941 and 940, NOT Schedule H. (SEE, IRS Publication 926, *Household Employer's Tax Guide*.)

Note also, that the household employee may be eligible for the Earned Income Credit (EIC), and may qualify for advance payment of EIC, if the employer is withholding Federal income tax. The employee must request the advance payment, providing a Form W-5, *Earned Income Credit Advance Payment Certificate*.

Importantly, a household employer must file Form W-2 for each household employee to whom \$1,500 or more of cash wages was paid in the calendar year, that was subject to Social Security and Medicare taxes. Also, if any Federal income tax was withheld from the wages paid to a household employee, a Form W-2 must be filed for that employee. Even if only one Form W-2 is being filed, beginning in 1997 it must be transmitted with Form W-3, *Transmittal of Wage and Tax Statements*. The "Hshld. emp." box should be marked on Form W-3.

Finally, household employers should keep copies of all employment tax forms and information filed --- Schedules H, Forms W-2, W-3, W-4 and W-5, and of supporting documentation, for at least four years after the due date of the return or after the date on which the taxes were paid, whichever is later.

State Employment Taxes

The compensation paid to household employees has been made exempt from "wages" by most states, for purposes of state income tax withholding. However, the payments represent taxable income to the employee. Therefore, the latter may request withholding, and the employer may agree to withhold, as noted above for Federal income tax withholding.

The usual test for employer liability for state unemployment insurance contributions is whether the employer pays cash wages to household employees of \$1,000 or more in a calendar quarter. However, some states have departed from this commonly-used test. For example, New York and the District of Columbia require coverage if the employer pays household employees cash wages of at least \$500 in any calendar quarter. Hawaii, Minnesota and Montana also have special threshold rules for coverage.

For both state income tax withholding requirements and liability for state unemployment insurance coverage, employers should check the state laws where the household employee works.

IN STATES WHERE FEDERAL AND STATE MINIMUM WAGE RATES DO NOT AGREE, WHAT IS THE CORRECT CHOICE?

Since September 1, 1997, the Federal minimum wage rate has been \$5.15 per hour. This rate is set forth in the Fair Labor Standards Act (FLSA) which establishes various workplace standards, including a minimum wage rate for employees not exempt from its coverage. The coverage of FLSA is based on the power delegated to Congress to regulate interstate commerce. In exercising this power, Congress generally limits itself to employers with annual sales of \$500,000 or more, AND at least two employees "engaged in interstate commerce" (broadly interpreted). Secondly, it excludes from coverage the workers in certain types of

jobs, such as executive, administrative and professional employees.

Normally, if an employer has annual sales of less than \$500,000, the FLSA's minimum wage rules do not apply. The only minimum wage rate applicable would be that of the state where the work is performed, if that state has a minimum wage requirement.

At \$2.65 per hour, only Kansas has a minimum wage rate lower than the Federal rate. In addition, six states (Alabama, Arizona, Louisiana, Mississippi, South Carolina and Tennessee) do not have a state minimum wage rate. So, if FLSA does not apply, employers in those six states are unregulated and may pay any hourly wage rate which gets employees to work for them. All other states have a state minimum wage rate equal to, or greater than, the Federal rate of \$5.15 per hour.

By way of contrast, suppose a Vermont company has annual sales of \$2 million. This company is subject to both the Federal rate of \$5.15 per hour and whatever minimum wage rate Vermont has legislated --- \$7.25 per hour, effective 1/1/2006. Importantly, because the Vermont rate is more favorable to employees than the Federal rate, the Vermont minimum rate must be applied. Obviously, the outcome would be the same if the Vermont company had annual sales of only \$250,000, exempting it from FLSA coverage in the first place.

There May Be A Different Result With Tipped Employees

The FLSA and many states permit employers to partially satisfy their regular minimum wage rate requirement by taking a credit based on a portion of the tips received already by the employee. This tip credit is controlled by requiring a special minimum cash wage for tipped employees, which varies in amount from state to state. The maximum tip credit amount can be determined by subtracting the minimum cash wage amount from the regular minimum wage.

Where an employer is subject to both the FLSA and the law of the state where the work is performed, the minimum cash wage rate most favorable to tipped employees must be used.

For example, a large Michigan restaurant with annual sales of \$1 million should pay the Michigan minimum cash wage rate of \$2.65 per hour, to its tipped employees --- not the Federal minimum cash wage rate of \$2.13 per hour. This restaurant employer is subject to both the FLSA (because its annual sales are \$500,000 or more) and to Michigan minimum wage laws (because the work is performed there). The choice is made by selecting the minimum cash wage rate most favorable to the tipped employee.

In addition to the seven states listed above which have no minimum wage requirements, seven other states and Puerto Rico have a state wage and hour law, but do not permit tip credit. Those states are: Alaska, California, Minnesota, Montana, Nevada, Oregon and Washington State. Finally, Georgia has a rule that any employee whose compensation consists wholly or partially of gratuities is exempt from Georgia's minimum wage law.

MARYLAND INCREASES MINIMUM WAGE

Effective February 16, 2006, the Maryland minimum wage increases from \$5.15 to \$6.15 per hour. For tipped employees, the required minimum cash wage increases from \$2.38 to \$3.08 per hour. Therefore, the maximum tip credit increases from \$2.77 to \$3.07 per hour.

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(April, 2005 through March, 2006)

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