

The Misnomers of Payroll Knowing The Facts About Putting An Employee On The Books

By: Evan M. Gilder

No one will argue that paying someone on the books is a chore and headache taking a chunk of your already precious time. The monthly and quarterly tax forms as well as the logistics around payroll are time consuming and burdensome. Yet, most people do not realize the consequence of their decision. Before you rush to conclusions, it makes sense to be aware of all the facts. Paying an employee "on the books" entitles the employer and the employee to significant tax savings and other important benefits. Take a closer look and see why the benefits of "being legal" far outweigh their costs. Aside from the fact that it's the law, here is a conclusive list of benefits:

<u>Employer Benefits</u>	<u>Employee Benefits</u>
<p>To lighten the burden that falls on working parents, Congress has enacted tax benefits for families through employer-provided dependent care assistance (Dependent Care Account) and the Tax Credit for Child or Dependent Care. However, these tax breaks are only available if the employee is paid legally, meaning all state and federal taxes are withheld and paid. We can advise you on the best tax break for you and how to take advantage of it.</p> <p><u>Dependent Care Account</u></p> <p>Many companies allow employees with child or dependent care expenses to contribute up to \$5,000 of their pretax earnings to an individual Dependent Care Account. The money in this account is then used to cover dependent care expenses, free of taxes.</p> <p><u>Tax Credit</u></p> <p>For those who don't have access to a Dependent Care Account, they can claim the Tax Credit for Child or Dependent Care on their income tax return at year-end. They can take a tax credit of 20% to 35% of qualifying childcare expenses (but only expenses of up to \$3,000 for one dependent or up to \$6,000 for two or more dependents can be counted).</p> <p>Only one of these tax savings options may be used each year. The Dependent Care Account usually provides the greater tax savings. Oftentimes, the tax savings exceed the employer's share of the taxes, actually saving money by being legal!</p> <p><u><i>Example:</i></u> A family in Boston hires a nanny to care for their children. She earns \$1,600 per month. The family contributes the maximum \$5,000 per year to their dependent care account at work. This account provides a tax savings of about \$2,250 per year, based on a 45% marginal tax rate. The employer's portion of the taxes amounts to about \$1,750 per year, so the employer saves about \$500 simply by paying his/her employee legally!</p>	<p>The benefits of being legal are numerous, and household employees really can't afford to be without them. Once you take a look at the benefits, you'll agree that the benefits of being legal far outweigh the cost of a slightly smaller paycheck!</p> <p><u>Employment History</u></p> <p>Being legal creates an employment history that is critical to daily life. If your employment is not documented, it is as if you do not work. An employment history is required for a car loan, a mortgage, a student loan, a credit card application, a health insurance application, an auto insurance application, future job applications, and the list goes on...</p> <p><u><i>Example:</i></u> A nanny in Washington worked for a family for five years and was paid illegally. Her car broke down and she had to buy a new one. However, because employment taxes had not been paid, the nanny could not provide proof of employment for the car loan!</p> <p><u>Unemployment Insurance</u></p> <p>When paid legally, you are entitled to receive unemployment insurance for up to six months if you lose your job due to no fault of your own. This benefit is free to you, as your employer pays the cost of the program.</p> <p><u><i>Example:</i></u> Jane lost her \$450 per week job as a nanny when her family had a job-related move across the country. Jane receives \$225 per week in unemployment insurance benefits while she looks for a new job. Assuming it takes her the maximum 6 months to find a new job, she will receive \$5,850 in total benefits.</p> <p><u>Social Security/Medicare Benefits</u></p> <p>For many, taking advantage of these benefits is years away, but consider these tax withholdings as a good investment.</p>

Employer Benefits (continued)	Employee Benefits (continued)
<p><u>Health Insurance</u></p> <p>Many household employers offer health insurance to their employees. This is a wonderful tax benefit for both employer and employee, as any payments made towards health insurance are not considered taxable wages. You can pay the healthcare premium directly to the health insurance company or pay the premium to the employee for her/him to pay to the health insurance company. If you pay the premium to the employee, keep a copy of a current health insurance card on file for proof of the policy.</p> <p><i>Example:</i> A family in Texas offers a nanny \$1550 per month, which includes a medical plan. The medical plan costs \$125 per month. The family reduces the monthly payroll to \$1425 and writes a check for the \$125 premium each month from their own bank account. Both nanny and family save the taxes on the \$125 monthly medical premium.</p> <p><u>It's Just Not Worth the Risk</u></p> <p>The IRS has made it much more difficult to plead ignorance of the law. As of 1995, federal household employment taxes are reported on Form 1040. Now, getting caught paying "under the table" could result in charges of perjury or even tax evasion, not to mention huge penalties and interest. It's just not worth the risk.</p> <p><i>Example:</i> A nanny in New York worked for a family for two years until the children went to school. The nanny was between jobs for a few months and filed for unemployment benefits. However, the family never paid their federal and state unemployment insurance. The nanny did not receive any unemployment benefits and the family "got caught." They had to pay thousands of dollars in back taxes, penalties and interest.</p> <p><u>Peace of Mind</u></p> <p>Being legal can actually save you money, our services make it hassle-free, and it provides your household employee with the benefits they deserve. "Paying "off the books" is too risky and it doesn't send the right message to the caregiver. If you really respect them, and they are taking care of the most important people in your lives, I think it's fair to give them all the benefits that they deserve, to pay them legally, and to care about their future."</p>	<p><i>Example:</i> Barb earns approximately \$20,000 per year. During her career she contributes about \$38,000 to Social Security. At age 65, she will receive approximately \$175,000 in Social Security benefits during retirement, assuming she lives until age 85. That's almost 400% more than the amount she contributed during her working years!</p> <p><u>Disability Benefits</u></p> <p>In many states, employees pay State Disability Insurance as a part of the taxes withheld. If you must take time away from work due to non-occupational illness or maternity leave, you are entitled to benefits while you are away from work.</p> <p><i>Example:</i> Maria is a full-time household employee and is expecting a baby. Maria is planning to take several weeks maternity leave. Her employer plans to hire a temporary caregiver while she is away and cannot afford to pay Maria during her leave. Maria plans to file for disability benefits to assist her during maternity leave.</p> <p><u>Earned Income Credit</u></p> <p>Employees may be able to receive the Earned Income Credit (EIC), which can eliminate some or even all federal taxes owed. The EIC is available to employees who have at least one qualifying child and expect to earn less than \$33,030 in 2005. A qualifying child is a dependent under 19, or under 24 if they are a full-time student. Form W-5 provides specific instructions for determining if an employee qualifies.</p> <p><i>Example:</i> Jackie earns \$1,200/month as a household employee and has two children, ages 15 and 17. Jackie is eligible for the Earned Income Credit since she has two qualifying children and her annual income is less than \$33,030. Her employer withheld \$1,102 in FICA and \$275 in federal income taxes during the year. However, she is entitled to an EIC of about \$3,800, which offsets all of her taxes and provides her with over \$2,400 extra! In other words, she will take home over \$2,400 more than if she had been paid cash illegally!</p> <p>Being legal can actually save you money, our services make it hassle-free, and it provides your household employee with the benefits she/he deserves. Paying "off the books" is too risky and it doesn't send the right message to the caregiver. If you really respect them, and they are taking care of the most important people in your lives, I think it's fair to give them all the benefits that they deserve, to pay them legally, and to care about their future.</p>

Let me take a second and talk about the growing popularity of Long Term Care policies. While the provisions vary tremendously, most policies require you to submit receipts to the insurance company in order to be reimbursed for covered expenses on the policy. The only acceptable form of reimbursable expense is someone who is on the books. While a home care agency certainly qualifies as a covered expense, it is usually a more costly option, which is something that must be seriously considered when there is a maximum daily out of pocket payment.

Now that you are aware of these benefits, let's consider the other side of this picture, such as some of the inadvertent ways one might get caught. Please note that in these scenarios, these are for someone you are on good terms with:

1. **Unemployment:** You terminate your nanny's employment. She's now out of work and files for unemployment benefits. When asked about her last place of employment, she names you. There are no records of you paying employment taxes.
2. **Workers Compensation:** Your nanny gets hurt while working in your home. Now she can't work but still needs to pay her bills, so she files for workers compensation. Because you hired your nanny illegally, you didn't/couldn't get workers compensation insurance, she reports you in order to obtain benefits.
3. **Social Security:** Your nanny is older and wants to retire. Upon retiring, she claims social security benefits. Her benefits are lower than she expected, and she realizes that for the time you employed her illegally, she wasn't contributing to social security. To obtain more benefits, she reports her employment with you to the Social Security Administration.
4. **Taxes:** You think you're smart and describe your nanny as an independent contractor responsible for her own taxes. Then your nanny's tax bill comes due and she realizes that she's responsible for both the employer's and employee's share of Social Security and Medicare, resulting in a much larger tax bill than she expected.

Sample Payroll Stub

ADVICE OF DEPOSIT Date: 11/01/2006

Net Pay: \$ 2999.77

PAY		Hours	Rate	Current	YTD	TAXES WITHHELD		Current	YTD
Salary				2910.67	32083.37	Federal Income Tax		777.13	6299.72
Bonus				1650.00	7483.34	Social Security		283.14	2453.14
						Medicare		66.22	573.72
						NY Income Tax		279.37	3033.33
						NY City Income Tax		161.04	1211.04
						SUMMARY		Current	YTD
						Total Pay		\$4,566.67	\$39,566.71
						Deductions		\$0.00	\$0.00
						Taxes		\$1,566.90	\$12,570.95
								Net This Check: \$2,999.77	
								Acct# -5303: \$2,999.77	
						EMPLOYER TAXES		Current	YTD
						FUTA Employer		0.00	\$6.00
						Social Security Employer		283.14	2453.14
						Medicare Employer		66.22	573.72
						NY Unemployment		0.00	6.38
						NY SUI Employer		0.00	342.12
						Total		\$349.36	\$3,481.36

941 Employer's Quarterly Federal Tax Return

Name (as recognized from trade name) **World Class Productions, Inc.** Date quarter ended **03/31/2006**

Employer identification number **12-3456789**

Address (number and street) **Park City, UT 84099**

City, state, and ZIP code

Number of employees in the pay period that includes March 15th: **1**

Total wages and tips, plus other compensation: **4,566.67**

Total income tax withheld from wages, tips, and other pay: **1,566.90**

Adjusted total of social security and Medicare taxes (line 8 or adjusted by line 9—see instructions): **673.26**

Adjusted total of social security and Medicare taxes (line 8 or adjusted by line 9—see instructions): **673.26**

Total taxes (add lines 9 and 10): **1,566.90**

Advance earned income credit (EIC) payments made to employees: **0.00**

Net wages (add lines 12 and 13, if \$2,000 or more; this amount equal line 11, volume III below for line 12 of Schedule B of Form 941-E): **2,999.77**

Total deposits for quarter, including overpayment applied from a prior quarter: **2,999.77**

Balance due (add lines 14 from line 10; see instructions): **0.00**

Overpayment, if line 14 more than line 13, enter amount from **5**

All filers (if line 13 is more than \$2,000, you must not complete line 13 or Schedule B (Form 941-E))

Signature: **Gregory Johnson** Date: **03/28/06**

Now imagine what could occur if you have words with your employee and then you realize how much power he/she can have for revenge. Not convinced yet? Well, think about the consequences of getting caught. Because you must report household employment taxes on your personal federal tax return, failure to pay the appropriate taxes constitutes "federal tax fraud". We'll leave the state tax fraud issue alone at the moment for purposes of simplicity. Those three little words subject you to the following consequences:

- Payment of all back taxes, penalties and interest.
- Federal charges of fraud and tax evasion.
- Classified as a Felony, where civil and criminal penalties, including fines, potential imprisonment, and a criminal record.

And these examples don't even factor in a disgruntled person, upset over some perceived slight, who quits and turn you in (or worse yet, tries to blackmail you). How about a neighbor/co-worker/family member who is envious or has always had a grudge against you and reports you. Or perhaps the IRS decides to audit you and notices the large amounts of cash or checks flowing out of your bank account every two weeks and gets suspicious. Under any of these scenarios, the result is the same: **YOU GET CAUGHT** and face the consequences, including paying all back taxes, interest, fines, civil and criminal penalties and potentially ruining your reputation and career.

Being labeled a tax cheat is bad enough; but it can ruin your reputation and career, especially if you're an attorney, accountant, financial advisor, or any professional who trades on integrity and has professional credentials. Being labeled a "tax cheat" isn't good for anyone's business. Furthermore, many state laws require that if you've been charged with a felony, you must report the charge to the state bar or professional certifying organization, regardless of guilt, jeopardizing your ability to practice and earn a living.

Oh, and by the way, if you advise your nanny not to pay her own taxes, that results in additional charges of fraud and conspiracy, with penalties of up to three to five years, respectively, as well as fines of up to \$250,000. Also, don't forget that there is no statute of limitations for failure to report and pay federal employment taxes.

In addition to these penalties, you undoubtedly will pay significantly more in professional fees to lawyers to defend you in an audit or criminal prosecution than you ever would have spent paying your nanny legally. How can we forget what happened to the career of Bernard Kerik, former New York City Police Commissioner and President Bush's nominee for Secretary of Homeland Security and other notable people whose careers and reputations were smeared in the newspapers as a result of being caught.

Remember, the government does not give out free tax deductions easily; they require work! But the benefits far outweigh the costs and the risks.

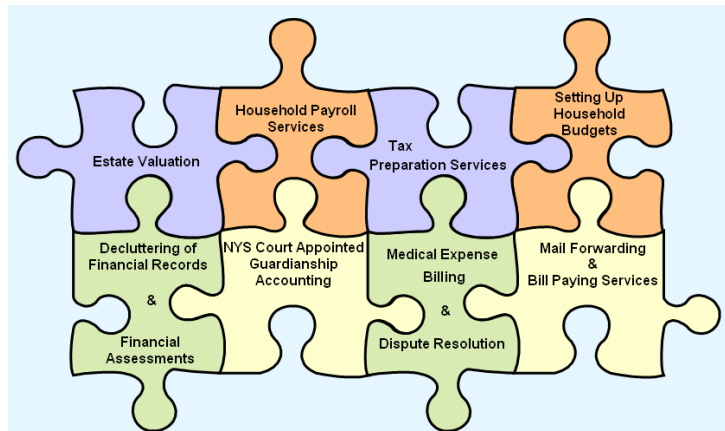
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About Redlig Financial Services:

Redlig Financial Services serves the needs of busy families, small businesses, expatriates and the elderly throughout the New York area. We provide a wide range of personal assistance to clients, who want help with their financial affairs, or those of a loved one. They include household and small business payroll services, income tax preparation and filing, daily money management and bill paying, medical expense billing and dispute resolution, and all other aspects associated with family finances.

Our payroll system is unique and really one of a kind. It was specifically designed for households and small businesses that take the complexity of payroll and automating all aspects of the process. With our service, everything is electronic, from the withdrawal of funds from the employer's account to the direct deposit of funds into the employees account. All monthly, quarterly and year-end tax forms with the Federal and State tax authorities are performed electronically as well. That translates into less paperwork and minimal time on your behalf.

It's all part of our role as Trusted Financial Advisor. While our services are broad and diverse, it is purposely designed to meet the needs of complicated family financial issues. While it is clear that not everyone needs all of our services, our business model is built around picking the right services to complete your specific financial puzzle and then add to it as needed.



For more information on our services, please feel free to visit us online at www.redlig.com. With our main office conveniently located in White Plains, NY, please feel free to contact us at 914-946-7725 or email us at egilder@redlig.com.