

# Who is Minding the Nanny Tax?

Report Prepared for the International Nanny Association

Brian Erard

*B. Erard & Associates*

e-mail: [brian@brianerard.com](mailto:brian@brianerard.com)

Phone: 703-390-9368

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## Executive Summary

Households are generally responsible for filing and remitting various federal and state employment taxes, commonly subsumed under the moniker "the Nanny Tax", when they employ domestic help, such as a nanny, senior caregiver, housekeeper, health aide, cook, or gardener. The largest of these taxes are the federal Social Security and Medicare taxes administered under the Federal Insurance Contributions Act (FICA), which are applied at a combined rate of 15.3% to the wages of any household employee who is paid more than \$2,100 over the course of a year. Household employers are also responsible for federal unemployment taxes administered under the Federal Unemployment Tax Act (FUTA). Besides these federal taxes, a household employer is generally required to remit certain state payroll taxes.

Failure to pay the Nanny Tax has resulted in numerous high profile scandals involving political appointees of every U.S. president from Clinton to Trump. These "Nannygate" cases are symptomatic of a pervasive, but understudied, compliance problem. Improving our understanding of Nanny Tax evasion is important, not only because it is a potentially significant source of federal and state revenue leakage, but also because of its adverse implications for a particularly vulnerable class of workers. Among those who are legally authorized to work, the Nanny Tax serves as the pathway through which domestic workers are able to access unemployment insurance, Social Security, Medicare, and other employment-related benefits. Being paid over the table also helps domestic workers to establish the credit needed to rent an apartment, purchase a car, obtain a mortgage, or secure a personal loan. At the same time, all of the various labor market and social issues that surround the topic of illegal immigration are relevant, because a sizeable share of unauthorized immigrants support themselves and their families by providing personal services to households. Compliance with the Nanny Tax involves important interactions between a relatively well-off segment of the population and a relatively poor segment. These interactions are complicated by an inadequate understanding among both segments regarding their rights and responsibilities.

Despite past legislative efforts to reduce the compliance burden associated with household employment taxes, noncompliance with the Nanny Tax has mushroomed. In this study, we perform a systematic and detailed analysis of the extent to which household employers fail to comply with their federal Nanny Tax obligations. We find evidence of pervasive noncompliance.

Household employers are required to file Schedule H (*Household Employment Taxes*) annually with their individual income tax returns to report and remit the federal payroll taxes

## Who is Minding the Nanny Tax?

for their employees. As indicated in the chart below, we find that only 5.3% of the estimated 3.6 million household employers in 2015 actually complied with this requirement.

### Estimated Nanny Tax filing compliance rate for tax year 2015

	Number of Schedule H Returns (Thousands)
Actual	191
Required	3,600
<b>Compliance rate</b>	<b>5.3%</b>

As summarized in the chart below, we estimate that household employers failed to report and remit from \$2.4 billion to \$4 billion in federal payroll taxes for tax year 2015. When household employers pay their workers under the table, the employees are unlikely to report those earnings on their income tax returns. We estimate that this resulted in between \$980 million and \$1.7 billion in unpaid federal individual income taxes for tax year 2015. Overall, then, the combined estimated federal payroll and individual income tax gap associated with household employment earnings amounts to between \$3.3 and \$5.7 billion, which implies that only 22% to 32.4% of all required taxes were actually reported and remitted. Evidence from Consumer Expenditure Survey data on household expenditures for child care in one's own home suggests that the higher end of this range is quite plausible. These estimates do not even account for unpaid state income and payroll taxes.

### Estimated Nanny Tax gap for tax year 2015

Tax Source	Lower Bound (\$ Millions)	Upper Bound (\$ Millions)
Payroll Taxes	2,370	4,029
Employee Income Taxes	979	1,666
<b>Total Tax Gap</b>	<b>3,349</b>	<b>5,695</b>
<b>Compliance Rate</b>	<b>32.4%</b>	<b>22.0%</b>

This massive level of noncompliance is partly attributable to a knowledge gap. Many household employers are blissfully ignorant of their Nanny Tax responsibilities and the risks and penalties associated with noncompliance – a problem that has been compounded by a lack of clear guidance from the IRS on what constitutes an employer-employee relationship.

## Who is Minding the Nanny Tax?

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Inadequate enforcement also has played a role. Even relatively thorough tax audits fail to adequately probe for and detect Nanny Tax evasion. In order to persuade household employers to mind the Nanny Tax, it is necessary to address these knowledge and enforcement gaps. To address the knowledge gap, we propose that the IRS:

- Team with other stakeholders, including tax preparers, household employee advocacy groups, and state revenue authorities to:
  - Identify ways to simplify Nanny Tax compliance;
  - Clear up Nanny Tax misconceptions; and
  - Educate household employers and their employees regarding their rights and responsibilities.
- Revise its publications on household employment to more plainly state the Agency’s position on the circumstances under which domestic workers are deemed to be household employees.
- Introduce an online application similar to the “employee/contractor decision tool” that the Australian Taxation Office makes available to its taxpayers. This easy-to-use application takes the user through a series of questions that lead to a clear determination of whether a worker is an employee or an independent contractor. Provided that the user has given accurate responses to the questions, the user can then rely on this determination for tax purposes. A record of the user’s responses and the resulting determination can be downloaded by the user to demonstrate due diligence in the event of an audit.
- Consider working with lawmakers to establish a rebuttable presumption that an employer-employee relationship exists when a household hires workers to perform personal services in or around the home. The burden would then be placed on the household to rebut this classification, for instance by providing evidence that the worker operates or is employed by a business that has the right to control how the work is performed.

To address the enforcement gap, we propose a tailored enforcement strategy along the lines of the compliance campaigns that the IRS has begun rolling out to address specific large and international business compliance issues. An important objective of this campaign should be to make the perceived risk of detection and punishment more salient to Nanny Tax violators so as to disrupt the existing culture of tax noncompliance. To achieve this goal, the IRS should:

## Who is Minding the Nanny Tax?

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- Allocate more resources to Nanny Tax enforcement.
- Develop more effective methods to probe for the presence of domestic workers.
- Apply these methods more routinely during audits, especially when examining returns that fit the profile for Nanny Tax noncompliance.
- Introduce strategies to promote compliance among domestic workers as well as their employers.
- Consider offering an amnesty prior to the launch of the compliance campaign as a potential way to encourage Nanny Tax evaders to come forward voluntarily and to ease the transition to a tougher enforcement regime.
- Revisit with lawmakers the special exemption of household employers from income tax withholding responsibilities.

Beyond addressing the knowledge and enforcement gaps, it is important to reduce the compliance burden associated with the Nanny Tax. Although the introduction of Schedule H simplified compliance with federal payroll requirements to some degree, it did nothing to address the state-level Nanny Tax compliance burden. The IRS and state tax administrations should work together on ways to coordinate and simplify the overall compliance process.

# Who is Minding the Nanny Tax?

## 1. Introduction

Households are generally responsible for filing and remitting various federal and state employment taxes, commonly subsumed under the moniker "the Nanny Tax", when they employ domestic help, such as a nanny, senior caregiver, housekeeper, health aide, cook, or gardener. The largest of these taxes are the federal Social Security and Medicare taxes administered under the Federal Insurance Contributions Act (FICA), which are applied at a combined rate of 15.3% to the wages of any household employee who is paid more than \$2,100 over the course of a year. Household employers are also responsible for federal unemployment taxes administered under the Federal Unemployment Tax Act (FUTA) when they pay their employees more than \$1,000 in any quarter of the current or preceding calendar years. FUTA tax is normally applied at a rate of 0.6% of wages.<sup>1</sup> Besides these federal taxes, a household employer is generally required to remit certain state payroll taxes. In addition to state unemployment insurance contributions, these payroll taxes may include disability and/or workers' compensation insurance, depending on the state where the work is performed.

Failure to pay the Nanny Tax has resulted in numerous high profile scandals involving political appointees of every U.S. president from Clinton to Trump. This ongoing parade of "Nannygate" cases is symptomatic of a pervasive, but understudied, compliance problem.<sup>2</sup> Improving our understanding of Nanny Tax evasion is important, not only because it is a potentially significant source of federal and state revenue leakage, but also because of its adverse implications for a particularly vulnerable class of workers. Among those who are legally authorized to work, the Nanny Tax serves as the pathway through which domestic workers are able to access unemployment insurance, Social Security, Medicare, and other employment-related benefits. Being paid over the table also helps domestic workers to establish the credit needed to rent an apartment, purchase a car, obtain a mortgage, or secure a personal loan. At the same time, all of the various labor market and social issues that surround the topic of illegal immigration are relevant, because a sizeable share of unauthorized immigrants support themselves and their families by providing personal services to households. Compliance with the Nanny Tax involves important interactions between a relatively well-off segment of the population and a relatively poor segment. These interactions are complicated by an inadequate understanding among both segments regarding their rights and responsibilities.

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<sup>1</sup> The FUTA tax rate is higher for employers who do not make timely state unemployment tax payments as well as for employers who reside in a credit reduction state.

<sup>2</sup> For those interested in delving into other research on Nanny Tax compliance, see the excellent studies conducted by Bloomquist & An (2006) and Haskins (2010).

In this study, we perform a systematic and detailed analysis of the extent to which household employers fail to comply with their federal Nanny Tax obligations. We find evidence of pervasive noncompliance. According to our estimates, only 5.3% of household employers file Schedule H (*Household Employment Taxes*) with their individual income tax returns and remit the required payroll taxes for their domestic employees. Overall, only \$1.1 billion in payroll taxes were remitted with Schedule H in 2015, leaving an estimated revenue gap of between \$2.4 billion and \$4 billion. Evidence from Consumer Expenditure Survey data on household expenditures for child care in one's own home suggests that the higher end of this range is quite plausible. When domestic workers are paid under the table, they are unlikely to pay income tax on their earnings. We estimate that the failure to report earnings from domestic work results in a federal individual income tax gap of at least \$979 million and likely closer to double this amount. These estimates do not even account for unpaid state level obligations of household employers for unemployment, disability, and workers' compensation insurance or the unpaid state income tax obligations of their employees.

The remainder of this study is organized as follows. Section 2 reviews the historical trend in Schedule H filings, which points to a large and growing problem with Nanny Tax compliance. Section 3 provides a preliminary, albeit incomplete, picture of the domestic employee workforce based on Current Population Survey data on individuals who report that their longest job during the year was as a private household worker. Even this partial picture reveals evidence of a substantial compliance problem. In Section 4, we extend our analysis to account for individuals who moonlight as domestic workers and individuals who were employed as a private household worker for only a portion of the year (and who worked more hours at a different job). Accounting for these workers is challenging, because the monthly Current Population Survey that we rely on only inquires about employment status at a point in time (the survey reference week). In Section 5, we exploit the longitudinal sampling design of this survey to translate our point-in-time count of domestic workers into a count of individuals who worked for a private household at least for a portion of the year. In Section 6, we address several other measurement issues, including survey undercount of foreign-born residents, domestic workers with earnings below the Schedule H filing threshold, and domestic workers who have multiple employers (and hence are potentially associated with a separate Schedule H filing requirement among each of their employers). After accounting for these issues, we derive our estimate of federal payroll tax filing noncompliance among household employers, which indicates that extremely few household employers comply with their filing requirements. In Section 7, we develop estimates of the federal payroll tax gap among household employers as well as the federal individual income tax gap among household employees. Our estimates indicate a massive level of noncompliance. In Section 8, we examine statistics on household expenditures for in-home child care based on the Consumer Expenditure Survey. The

consistency of these reported expenditures with our estimates of domestic child-care worker earnings provides support for our Nanny Tax gap estimates. In Section 9, we summarize the demographic characteristics of domestic workers. The vast majority of these workers are female, and about 46% are foreign-born residents. The foreign-born domestic workers are almost evenly split between lawful and unlawful immigrants. In Section 10, we conclude by proposing measures that the IRS should undertake in order to begin closing the Nanny Tax gap.

### **2. Schedule H filing trend**

Nanny Tax compliance became a subject of national attention and Congressional scrutiny following the withdrawal of Zoë Baird's nomination for Attorney General in 1993 stemming from revelations that she had illegally employed unauthorized immigrants as domestic workers and had also failed to file and remit the required payroll taxes.<sup>3</sup> The ensuing investigations exposed that Nanny Tax evasion was, in fact, a widespread problem. Only approximately 500,000 household employers filed and remitted payroll taxes in 1994 (IRS finds more people, 1998). According to IRS estimates, this group of filers represented less than one fourth of all household employers with a federal payroll tax obligation (H.R. Rep. No. 103-491, 1994).

At that time, a household employer was required to file Form 942 (Employer's Quarterly Return for Household Employees) to report and remit Social Security and Medicare taxes for any domestic worker who was paid more than \$50 in cash wages during the calendar quarter. In addition, a separate annual filing of Form 940 was required to report and remit applicable FUTA taxes.<sup>4</sup> Schedule H was introduced in tax year 1995 as a measure to reduce the federal compliance burden faced by household employers and to improve their compliance. Under the new law, the employer now only had to submit an additional form (Schedule H) with its annual individual income tax return to report all federal payroll taxes for its domestic employees (including Social Security, Medicare, and FUTA taxes).<sup>5</sup> As well, the \$50 quarterly threshold for Social Security and Medicare taxes was replaced by an inflation-indexed annual threshold of \$1,000, and babysitters under the age of 18 were exempted from all payroll tax requirements.<sup>6</sup>

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<sup>3</sup> Although it is against the law for a household employer to hire an unauthorized immigrant, the employer remains subject to all tax withholding, reporting, and remittance requirements, regardless of whether its employees have proper work authorization.

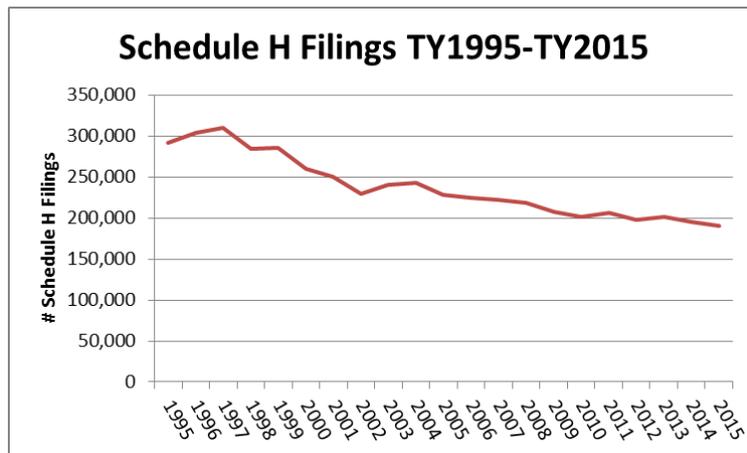
<sup>4</sup> A quarterly remittance of FUTA taxes was required for employers who owed more than \$100 at the end of a calendar quarter.

<sup>5</sup> Household employers continue to have a requirement to report wages annually on Forms W-2 and W-3, and they must obtain an employer identification number (EIN).

<sup>6</sup> An exception is that babysitters under the age of 18 who are not students and for whom child care is their primary occupation are subject to federal payroll taxation. Children under the age of 21 who are paid by their parents to babysit are also exempt from payroll taxes. Babysitting of grandchildren by grandparents is also generally exempt.

## Who is Minding the Nanny Tax?

Although it was hoped that, by simplifying and streamlining the filing process, tax compliance would improve over time, the immediate effect of the legislation was that roughly 200,000 fewer household employers filed and remitted payroll taxes for tax year 1995 (a 40% drop in filings). As shown in the chart below, Schedule H filings grew only modestly over the next two years, with filings peaking at about 310,000 in tax year 1997. From that year on, Schedule H filings have declined precipitously, falling to slightly fewer than 191,000 by tax year 2015.<sup>7</sup> As Bloomquist & An (2005) and Haskins (2010) have previously noted from this emerging trend, the sharp decline in Schedule H filings reflects a large and growing compliance problem.



### 3. Domestic work as a main job

One can obtain an initial, albeit incomplete, picture of the domestic employee workforce from the Annual Social and Economic Supplement of the Current Population Survey (CPS-ASEC). This annual survey collects socio-economic and demographic information for more than 185,000 members of a multi-stage probability sample of over 100,000 U.S. households each year. The information collected includes comprehensive details regarding employment and earnings associated with one's longest-held job during the preceding calendar year. Domestic workers are assigned to the four-digit industry category 9290 (Private Household Workers) in the CPS-ASEC, which corresponds to the three-digit NAICS industry category 814.

Table 1 breaks down the occupations of workers over the age of 17 with a longest job in this industry in 2015.<sup>8</sup> According to these statistics, there were approximately 734,000 workers whose longest job was as a domestic employee in 2015. Maids/housekeepers account for the

<sup>7</sup> Filing statistics were obtained from the annual IRS Statistics of Income Individual Income Tax Return Statistics publications for tax years 1995-2015 (Internal Revenue Service, 1997/2017).

<sup>8</sup> The CPS-ASEC and monthly CPS public use files were retrieved from the National Bureau of Economic Research (NBER) website: <http://www.nber.org/cps/>.

## Who is Minding the Nanny Tax?

largest share of these workers (46.7%), followed by child caregivers (30.5%) and personal home care aides (15.9%). Other occupations, such as cooks, gardeners, and health aides, account for the remaining 6.9% of these workers.

**Table 1: Individuals over age 17 who were employed as domestic workers in their longest-held job in 2015**

<b>Occupation</b>	<b>Number of Employees</b>	<b>Percentage of Total</b>
Maid/Housekeeper	342,613	46.7%
Child Caregiver	223,640	30.5%
Personal Home Care Aide	116,903	15.9%
Other Miscellaneous	50,488	6.9%
<b>Total</b>	<b>733,645</b>	<b>100.0%</b>

Based on their reported earnings, over 637,000 of these 734,000 domestic workers earned more than the tax year 2015 Nanny Tax threshold of \$1,900. Thus, even if we were to restrict our attention to one's longest-held job during the year and assume that each domestic employee had a single household employer, we would conclude that at least 637,000 household employers were potentially subject to federal Nanny Tax filing requirements for tax year 2015. Therefore, the fact that fewer than 191,000 Schedule H returns were actually filed for this year points to a serious compliance problem.

Below, we undertake a more comprehensive analysis to obtain a clearer picture of the actual scope of the problem. To the fullest extent possible, we exploit data on moonlighters and job changers, survey undercounts of unauthorized immigrants, and industry classification challenges to estimate the degree to which household employers comply with federal filing and remittance requirements. We also estimate the amount of federal individual income tax that goes unpaid by their employees on their earnings. Our estimates, while conservative, indicate massive noncompliance. We conclude by offering some suggestions for improving compliance.

#### **4. Accounting for moonlighters and job changers**

The analysis presented in Section 3 was restricted to workers who reported that their longest-held job in 2015 was as a domestic employee. Therefore, it did not account for Individuals who moonlighted as domestic workers or those who worked for a household employer for a portion of the year but worked for a longer portion of the year at a different job. To address these issues, we rely on the monthly Current Population Survey (CPS). Under the monthly survey program, socio-economic and demographic information is collected regarding approximately

## Who is Minding the Nanny Tax?

130,000 residents from a multi-stage probability sample of roughly 50,000 households from the overall civilian non-institutional population. Information on the main job held during the prior week is collected for all individuals over the age of 15. Table 2 presents the weighted monthly counts of all individuals over the age of 17 who reported working as a domestic employee on their main job in 2015.<sup>9</sup> The counts range from about 719,000 to 922,000, depending on the survey month. The weighted average count across months is approximately 790,000. This figure is larger than the CPS-ASEC estimate of 734,000 individuals with a longest-held job as a domestic worker in 2015. This makes sense, because the monthly CPS figures reflect the main job held by an individual during the reference week, which is not necessarily the longest-held job over the course of the year.

**Table 2: Weighted monthly counts of domestic workers over age 17 in 2015 based on main job held in prior week**

Month	Number of Workers
January	922,107
February	824,581
March	782,102
April	786,073
May	754,253
June	843,771
July	765,204
August	807,014
September	718,653
October	799,012
November	745,001
December	730,612
<b>Weighted Average</b>	<b>789,858</b>

The monthly CPS survey also inquires about any work performed on a second job during the prior week for about one-fourth of all individuals over the age of 15 (the “outgoing rotation group”). The weighted average number of individuals who reported holding a second job as a domestic employee during the survey reference week (but not their main job) in 2015 is 68,861. Thus, an average of almost 859,000 individuals reportedly held either a main or a second job as a domestic employee in any given month of 2015.

<sup>9</sup> These counts include individuals who either were employed (regardless whether present or absent from work in the prior week) or on layoff.

A limitation of these monthly figures is that they capture employment status only at a single point in time during the year. Consequently, they fail to identify individuals who worked as a domestic employee over a portion of the year, but not during the survey reference week. This issue is addressed below in Section 5.

### 5. Adjusting for point-in-time measurement limitations

To examine the extent to which the monthly CPS point-in-time measures of domestic employment from Section 4 understate the number of individuals who worked at least a portion of the year as domestic workers, we take advantage of the longitudinal nature of the CPS sampling design. The monthly survey includes eight panels or rotation groups, with two new groups brought into rotation each month and two retired. Households in each rotation group are interviewed once a month for four consecutive months and then are interviewed again during the same four months of the subsequent year. By appropriately matching individuals across the monthly surveys, one can therefore identify how an individual's employment status varies over different months. To perform these matches, we have relied on the matching variable "CPSIDP" provided by IPUMS-USA (see King et al., 2010) as well as the CPS measures of reported gender, race, and age. By matching individuals across the 12 monthly surveys for 2015, we are able to observe a given individual's employment status up to a maximum of four times, depending on the rotation group of the household and other factors.<sup>10</sup>

Table 3 presents the unweighted frequencies of the number of monthly observations on matched individuals over the age of 17 in 2015.

**Table 3: Weighted number of monthly observations on matched individuals over age 17 from the monthly 2015 CPS surveys**

<b>Number of Monthly Observations</b>	<b>Weighted Count</b>	<b>Percentage of Total</b>
1	60,310	15.6
2	52,296	13.5
3	61,165	15.8
4	213,323	55.1
<b>Total</b>	<b>387,094</b>	<b>100.0</b>

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<sup>10</sup> For instance, a member of household that was in the fourth or eighth rotation group in January 2015, or the first or fourth rotation group in December 2015, would only be observed once over the twelve month period. In addition, it is not possible to definitively match all individuals across the relevant monthly samples, owing to changes in household composition, sample attrition, and occasional coding errors in the data samples; however, the success rate is quite high.

Rather than rely on a measure of whether an individual worked in a domestic occupation during the reference period of a single monthly survey, we would ideally like to employ a measure of whether the individual worked in a domestic occupation at any time during the year. As a step in that direction, we have computed the weighted average number of individuals who reported domestic work as their main job during any of the one, two, three, or four periods that they were subject to a CPS monthly survey in 2015.<sup>11</sup> This yields an estimate of 1.19 million domestic workers, which is almost 34% higher than the previous estimate 790,000 based on the weighted average number of respondents who reported having been employed as a domestic worker in their main job in a given survey month.

Even this 1.19 million estimate substantially understates the actual number of individuals who were employed as domestic workers at some point over the course of the year. Consider, for instance, the subsample of 1,001 individuals who were the subject of four separate monthly surveys during 2015 and who reported employment as a domestic worker in at least one of these four months. Each member of this subsample reported domestic employment status in one, two, three, or four of the months. Column (A) of Table 4 breaks down the weighted percentage frequency associated with each of these outcomes.

All of the members of this subsample were employed in a domestic occupation for at least a portion of the four month interval over which they received the surveys. However, the individual monthly surveys do not always permit accurate assignment of this status. For instance, Column (A) indicates that approximately one-third of the subsample reported having held a domestic job during only one of the four monthly surveys. Therefore, only one of the four monthly surveys (or 25% of the surveys) provides an indication that a member of this group was a domestic worker for at least a portion of the four month interval. Likewise, only 50% of the four monthly surveys correctly reflect this status among the 17% share of the subsample that reported domestic employment in two of the four interview months, and only 75% of the four monthly surveys correctly reflect this status among the 13% share of the subsample that reported domestic employment in three of the four interview months. The correct status would be consistently assigned in each month only for the 37% share of the subsample that reported domestic employment during all four monthly surveys. Therefore, if assignment of domestic employment status was based on individual monthly responses, members of the overall subsample would be correctly assigned as having been employed as a domestic worker at some point over the four month interval only about 63% of the time. In other words, the actual count of individuals who served as domestic workers for at least some portion of the four month interval would be understated by approximately 37%.

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<sup>11</sup> For this calculation, each individual's sample weight was computed as the sum of the weights across the months that the individual was sampled, divided by twelve.

## Who is Minding the Nanny Tax?

The reason that the previously-mentioned panel-based estimate implied a somewhat smaller percentage understatement (34%) is that some respondents were interviewed over fewer than four consecutive monthly surveys. In such cases, the respondents were assigned to domestic worker status based on their employment status over an interval of shorter than four months, thereby misrepresenting their true status over the entire four month period in some instances.

**Table 4: Weighted percentage of months with correct assignment of domestic worker status over four months in 2015 by number of monthly reports of domestic employment during reference period, individuals over age 17**

Number of Monthly Reports of Domestic Employment	Weighted Percentage Frequency (A)	Percentage of Months Correctly Assigned as a Domestic Worker (B)	(A) Times (B)
1	33.34%	25%	8.3%
2	16.96%	50%	8.5%
3	12.82%	75%	9.6%
4	36.88%	100%	36.9%
<b>Total</b>	<b>100.00%</b>		<b>63.3%</b>

In practice, we would like to count the number of individuals who served as domestic workers over some portion of 2015, not just during a four month interval of the year. To obtain a better sense of the extent to which assignment based on individual monthly responses leads to an understatement of this count, we have extended the CPS panel to include members of the monthly surveys from July 2014 through June 2016. Over this 16 month period, a given individual would have been included in up to eight monthly surveys. Table 5 repeats the analysis presented in Table 4 for the 463 individuals who participated in eight monthly surveys over this period. The results indicate that if our objective was to obtain a (weighted) count of the number of these individuals who held a job as a domestic worker over at least a portion of the eight interview months, assignment based on the individual monthly responses would

## Who is Minding the Nanny Tax?

understate the actual count by approximately 58%, meaning that the true count would be roughly 2.4 times as large as the computed count.<sup>12</sup>

**Table 5: Weighted percentage of months with correct assignment of domestic worker status over eight survey months between July 2014 and June 2016 by number of monthly reports of domestic employment during reference period, individuals over age 17**

Number of Monthly Reports of Domestic Employment	Weighted Percentage Frequency (A)	Percentage of Months Correctly Assigned as a Domestic Worker (B)	(A) Times (B)
1	31.52%	12.5%	3.94%
2	12.93%	25.0%	3.24%
3	11.24%	37.5%	4.22%
4	21.71%	50.0%	10.86%
5	1.83%	62.5%	1.144%
6	4.05%	75%	3.04%
7	6.73%	87.5%	5.89%
8	9.99%	100.0%	9.99%
<b>Total</b>	<b>100.00%</b>		<b>42.30%</b>

This analysis involving individuals who were surveyed during eight different months at least approximates the ideal situation in which individuals are surveyed in each month of a given year. Overall, it is reasonable to assume that 2.4 is a conservative adjustment factor for

<sup>12</sup> From Table 5, the overall chance of correctly identifying private household worker status is only 42.3%, implying an understatement of approximately 58%. Note that if we instead wanted to estimate the number of individuals who held a job as a domestic worker over at least a portion of the full sixteen month period, this adjustment factor would be too small, because it implicitly assumes that anyone with this status would have been working as a domestic employee at some point during the 8 interview months, ignoring those who only worked as a domestic employee at some time during the 8 non-interview months. In fact, the adjustment factor also does not take into account that the monthly interview only covers a one week reference period, thereby ignoring the possibility of employment as a domestic worker during one or more weeks of the interview month, but excluding the reference week.

translating our weighted average CPS monthly count of individuals who worked as domestic employees during the reference week into an estimated count of individuals who worked at least a portion of calendar year 2015 as domestic employees. Applying this adjustment factor to our initial count of 859,000 individuals who worked as domestic employees in their main or second job during the reference week yields an estimated count of 2.06 million individuals who held a domestic job during at least a portion of 2015.

### **6. Additional adjustments**

In this section we address the issues of survey undercount of foreign-born residents, domestic workers with annual earnings below the Schedule H filing threshold, and domestic workers with multiple household employers. After accounting for these issues, we compare our estimate of the number of required Schedule H filings in 2015 to the actual number of filings. The results indicate that only about 5.3% of all household employers comply with their federal payroll tax obligations.

#### **6.1 *Survey undercount***

Foreign-born residents are disproportionately represented within the domestic worker population. At the same time, they are underrepresented in national surveys, such as the CPS and the American Community Survey (ACS). To address this undercount problem, we rely on Pew Research Center estimates (DeSilver, 2017; Passel & Cohn, 2016), which indicate that foreign-born private household workers are undercounted by approximately 4.2%. Applying this adjustment factor to foreign-born domestic workers in the monthly CPS samples modestly increases our overall estimate from Section 5 of 2.06 million domestic workers in calendar year 2015 to approximately 2.1 million.

#### **6.2 *Annual earnings below Schedule H filing threshold***

Although \$1,900 is a rather modest annual earnings threshold for a Schedule H filing requirement, not all of these 2.1 million workers would have reached this threshold. After adjusting for undercount of foreign-born residents, our estimate based on CPS-ASEC is that 649,000 of the roughly 746,000 individuals (87%) whose longest-held job in 2015 was as a private household worker actually had domestic employment earnings in excess of \$1,900.

Multiplying 2.1 million by this percentage yields an estimated 1.82 million domestic workers associated with at least one Schedule H filing requirement.<sup>13</sup>

### **6.3 Domestic workers with multiple employers**

Table 6 breaks down this overall count of 1.82 million individuals over the age of 17 who earned more than \$1,900 from a main or second job as a domestic worker in 2015 according to occupation. As the combined CPS monthly sample size is quite large, it is feasible to provide a somewhat more detailed breakdown of occupation categories than was possible with the CPS-ASEC sample in Table 1. The occupation shares based on the main and second job presented in Table 6 are quite similar to those presented for the longest-held job over the course of the year in Table 1. Again, the highest shares are associated with maids/housekeepers (45.8%), child caregivers (30.1%), and Personal Home Care Aides (16.4%). Nurses and home health aides account for 1.8% of all domestic employees, while cooks and food preparation workers account for another 0.8%. Other domestic occupations, such as gardeners and drivers, account for the remaining 5.1%.

Since many domestic workers are employed by multiple households, the number of required Schedule H returns is expected to be much larger than 1.82 million. For instance, it is common for housekeepers to clean many different homes over the course of a week. As well, many child care providers work in temporary or nanny-sharing arrangements over the course of the year. Table 6 includes a conservative estimate of the average number of employers for which domestic employees in different occupations work using figures that a Nanny Tax preparation service has shared with me based on its actual client experience.<sup>14</sup> Applying these figures, we estimate that these 1.82 million domestic employees had approximately 3.8 million household employers. However, the required number of Schedule H filings would be somewhat fewer than 3.8 million, because household employers with more than one employee over the course of the year are required to make only a single Schedule H filing.<sup>15</sup> To address this issue, we adjust our estimate downwards by 5% (to 3.6 million) based on client statistics on the share of Schedule H filings covering more than one employee that were provided to me by a Nanny Tax preparation service.

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<sup>13</sup> We believe that this is a conservative estimate owing to the reluctance of domestic workers who are paid under the table to disclose the true amount of their earnings on a survey or even acknowledge that they had employment earnings at all. See the discussion in Section 8.

<sup>14</sup> Household employers that use Nanny Tax preparation services are presumably more likely to have full-time permanent help than household employers that do not use these services. As a result, these figures are likely to understate the overall number of household employers in the population, which more frequently rely on part-time and temporary workers.

<sup>15</sup> A small number of household employers may choose to file Form 941 on a quarterly basis for their domestic employees rather than Schedule H. However, this is likely to be an unusual situation, so that my estimates remain conservative.

## Who is Minding the Nanny Tax?

Since only about 191,000 Schedule H returns were actually filed for tax year 2015, we estimate a filing compliance rate of only 5.3%, which is roughly comparable to the dismal level of compliance that states currently experience with respect to their consumer use taxes.

**Table 6: Frequency of domestic employees, average number of employers, and estimated number of required Schedule H filings by occupation**

Occupation	Frequency	Percentage Frequency	Average # Employers	Total # Employers
Maid/Housekeeper	834,111	45.8%	3	2,502,332
Child Caregiver	549,214	30.1%	1.5	823,821
Personal Home Care Aide	298,698	16.4%	1.1	328,568
Nurse/Therapist/Health Aide	32,818	1.8%	1.1	36,100
Cook/Food Prep. Worker	13,857	0.8%	1.1	15,242
Other Miscellaneous	93,734	5.1%	1.1	103,108
Total	1,822,432	100.0%	2.1	3,809,171
<b>Actual Number of Sch. H Filings</b>	<b>190,852</b>			
<b>Required Number of Sch. H Filings</b>	<b>3,619,000</b>			
<b>Sch. H Filing Compliance Rate</b>	<b>5.3%</b>			

### 7. Federal payroll and individual income tax gaps

In this section we develop an estimate of the tax gap associated with payroll taxes that go unreported by household employers. Often, when domestic workers are paid cash wages under the table, they fail to report the individual income tax on these earnings. We therefore also provide an estimate of the potential individual income tax gap among domestic employees.

#### 7.1 Payroll tax gap

In order to estimate the federal payroll taxes for which household employers are responsible, it is necessary to estimate the annual earnings of their employees. Aggregate reported earnings

were \$11.57 billion (\$17,822 per worker) among those CPS-ASEC respondents over the age of 17 who indicated that their longest-held job in 2015 was as a domestic worker and who had annual earnings in excess of \$1,900.<sup>16</sup> This tabulation based on longest-held jobs accounts only for 649,337 of the estimated 1.82 million individuals who worked at least a portion of the year as domestic employees. Social Security and Medicare taxes are applied at a combined rate of 15.3%. For employers who make timely state unemployment insurance contributions and who do not reside in a credit reduction state, the FUTA tax rate is 0.6%. Under the conservative assumption that workers accurately report their full earnings from domestic employment on the survey (inclusive of what they were paid under the table), the combined estimated payroll tax obligations for these 649,337 domestic workers, alone, amount to more than \$1.84 billion (0.159 x \$11.57 billion).

It is difficult to assess how the annual household employment earnings of individuals who moonlighted as domestic workers or worked only a portion of the year in a private household setting (and worked a larger portion of the year in a different job) compare to those who were employed as domestic workers on their longest-held job. It seems plausible that they would have had somewhat lower annual earnings from domestic employment. On the other hand, domestic workers may be reluctant to acknowledge and divulge under-the-table earnings on a survey. Therefore, \$17,822 most likely understates the true earnings of those who worked as domestic employees in their longest-held job during 2015, while it may overstate to some degree the average earnings of those who worked as domestic employees outside of their longest-held job. For our upper bound estimate in Table 7, we assume that these errors wash out, so that \$17,822 effectively represents the average true earnings of all domestic workers. For our lower bound estimate, we make the more conservative assumption that average true earnings among those who worked as domestic employees in their longest-held job in 2015 were equal to the reported value of \$17,822 (i.e., that these earnings were not understated on the survey) but that those with domestic employment outside of their longest-held job earned only half of this amount (\$8,911). Based on these alternative assumptions, we estimate that the combined estimated payroll tax obligations for all domestic workers in tax year 2015 amounted to between \$3.5 billion and \$5.2 billion.

Household employers actually reported only \$1.13 billion in payroll taxes on Schedule H in tax year 2015, leaving an estimated payroll tax gap of between \$2.4 billion and \$4 billion. In Section 8, we provide evidence from the Consumer Expenditure Survey that supports an estimate closer to the upper end of this range.

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<sup>16</sup> This estimate of \$17,822 is conservative in that it only includes earnings from the longest-held job in 2015. Some of the respondents may have had additional earnings from domestic work they did for another employer in that year, either as a result of a job change or from employment on a second job, which would be omitted from this estimate.

**Table 7: Federal payroll tax gap among household employers**

	Longest- Held Job	Other Job Lower Bound	Other Job Upper Bound	All Jobs Lower Bound	All Jobs Upper Bound
# Employees	649,337	1,173,095	1,173,095	1,822,432	1,822,432
Average Wages	\$17,822	\$8,911	\$17,822	\$12,086	\$17,822
Aggregate Wages (\$ Billions)	11.57	10.45	20.91	22.03	32.48
Payroll Taxes Owed (\$ Billions)	1.84	1.66	3.32	3.50	5.16
Payroll Taxes Remitted (\$ Billions)				1.13	1.13
<b>Payroll Tax Gap (\$ Billions)</b>				<b>2.37</b>	<b>4.03</b>
<b>Compliance Rate</b>				<b>32.4%</b>	<b>22.0%</b>

## 7.2 Individual income tax gap

We have developed a CPS-ASEC tax calculator to estimate the net federal individual income tax after refundable credits (specifically, the Earned Income Credit and the Additional Child Tax Credit) for domestic workers (and their spouses, in the case of joint filing status) both inclusive and exclusive of domestic employment earnings.<sup>17</sup> For the 649,337 individuals that report having a longest-held job during 2015 as a domestic worker, we estimate that the average income tax liability amounted to \$1,606 per worker when earnings from domestic employment were included, but only \$442 per worker when these earnings were excluded. Thus, the lion's share of the overall tax bill (\$1,164) was attributable to their domestic employment earnings. Based on these figures, domestic workers were subject to an average federal income tax rate of 6.58% on those earnings.<sup>18</sup>

In Table 8, we apply this average tax rate estimate of 6.58% to the earnings of all domestic workers to compute their aggregate tax liability.<sup>19</sup> Our calculations rely on the same lower and upper bound estimates of earnings that were used to compute payroll taxes in Table 7. The results indicate that domestic workers owed between \$1.45 billion and \$2.1 billion in aggregate income taxes on their employment earnings. We assume that domestic workers only paid their income taxes on these earnings when their employers remitted the associated payroll taxes. In the previous subsection, payroll taxes were paid on 32.4% of earnings based on the lower bound wage estimate and 22% based on the upper bound estimate. Under both the

<sup>17</sup> Unauthorized workers are not eligible for the Earned Income Credit (EIC). To address this, some foreign-born private household employees in our sample were randomly assigned as unauthorized workers and were denied the EIC in our tax calculations.

<sup>18</sup> The average tax rate on domestic earnings was close to 10% prior to the application of refundable credits.

<sup>19</sup> Note that we ignore potential income taxes on the wages of domestic workers whose earnings fell below the \$1,900 annual Nanny Tax threshold.

lower and upper bound scenarios, this implies an aggregate income tax payment of approximately \$470 million. After deducting taxes paid from taxes owed, we arrive at an estimated federal individual income tax gap ranging from \$979 million to \$1.67 billion.

**Table 8: Federal individual income tax gap associated with domestic employment earnings**

	Lower Bound (\$ Millions)	Upper Bound (\$ Millions)
Aggregate Wages	22,030	32,480
Income Tax on Aggregate Wages	1,449	2,135
Amount of Tax Actually Paid	470	470
<b>Income Tax Gap</b>	<b>979</b>	<b>1,666</b>
<b>Compliance Rate</b>	<b>32.4%</b>	<b>22.0%</b>

### 7.3 Summary of Nanny Tax gap estimates

Household employers are required to file Schedule H annually with their individual income tax returns to report and remit the federal payroll taxes for their employees. As indicated in Table 9, however, we estimate that only 5.3% of household employers actually comply with this requirement.

**Table 9: Estimated Schedule H filing compliance rate for tax year 2015**

	Number of Schedule H Returns (Thousands)
Actual	191
Required	3,619
<b>Compliance rate</b>	<b>5.3%</b>

Table 10 summarizes our estimates from Subsections 7.1 and 7.2 of the federal Nanny Tax gap for tax year 2015. We estimate that household employers failed to report and remit between \$2.4 and \$4 billion in federal payroll taxes for that year. When household employers pay their workers under the table, the employees are unlikely to report those earnings on their income tax returns. We estimate that this resulted in between \$979 million and \$1.7 billion in unpaid federal individual income taxes for tax year 2015. Overall, then, the combined estimated federal payroll and individual income tax gap associated with household employment ranges

from \$3.35 billion and \$5.7 billion in that year, which implies that only 22% to 32.4% of all required taxes were actually reported and paid. As discussed below in Section 8, evidence we have derived from the Consumer Expenditure Survey suggests that the upper bound (\$5.7 billion) of this estimated Nanny Tax gap range is quite plausible.

**Table 10: Estimated federal Nanny Tax gap for tax year 2015**

<b>Tax Source</b>	<b>Lower Bound (\$ Millions)</b>	<b>Upper Bound (\$ Millions)</b>
Payroll Taxes	2,370	4,029
Employee Income Taxes	979	1,666
<b>Total Tax Gap</b>	<b>3,349</b>	<b>5,695</b>
<b>Compliance Rate</b>	<b>32.4%</b>	<b>22.0%</b>

### 8. Evidence from the Consumer Expenditure Survey

In order to assess whether an individual was employed as a domestic worker, the CPS interviewer must collect information relating to the identity of the employer (i.e., that the person works directly for a household and not, say, for an incorporated business), the location where the work is performed (i.e., that the work is performed at the employer's own home), and the nature of the work. Individuals who are not authorized to work and those who are being paid under the table may be reluctant to share such details during an interview. Indeed, the CPS Interviewing Manual (U.S. Census, 2015) anticipates this problem. It states:

“Census employees in Jeffersonville, Indiana assign industry codes based on the employer name and the business or industry description you provide. Though some respondents are reluctant to provide the name of their employer, this information is very helpful in assigning the correct industry code. Without badgering the respondent, make every effort to collect this information. In some cases it may only be necessary to reassure respondents of the confidentiality of the survey data.” (p. B4-4)

The interviewing manual also cautions:

“Some respondents may be reluctant to provide information about themselves or family members or may refuse to be interviewed. It is your job to sell the survey.” (p. A2-6)

In practice, it seems unlikely that the interviewer will be successful in “selling the survey” in every instance involving a reluctant respondent. As a result, it is reasonable to expect that some respondents will not disclose sufficient information to the interviewer to permit an inference that the individual was a domestic worker when this was, in fact, the case. Likewise, some respondents are likely to understate their earnings from such employment or report that they had no earnings.

As a check on our CPS-based estimates, we have developed an estimate of the amount spent by households on child-care assistance in their own home using the Consumer Expenditure Survey (CEX). Although household employers may have some reluctance to reveal child-care expenses that they have paid under the table, it seems likely that they would be somewhat less averse to sharing such information than would employees with regard to their under-the-table earnings from child care work. Our CEX-based estimate is that households spent \$9.4 billion for child care assistance in their own home in 2015.<sup>20</sup> Although a portion of this amount represents payments to relatives or au pairs for babysitting, which are generally not subject to Nanny Tax, or domestic employee wages that fell short of the \$1,900 Schedule H filing threshold, most of it is attributable to annual payments to non-exempt domestic employees who earned more than \$1,900. Based on the estimated count of 549,214 private household child care workers from Section 5, this implies average annual earnings of \$17,115, which is within 4% of the average annual earnings reported in the CPS-ASEC among individuals who have indicated that their longest-held job was as a domestic child care provider (\$17,822). This finding suggests the upper ends of the estimated ranges of the household employer tax gap (\$4 billion) and the domestic worker individual income tax gap (\$1.7 billion) are quite plausible.

### **9. Demographic characteristics of domestic workers**

Table 11 presents summary statistics on the demographic characteristics of private household workers. Strikingly, almost 93% are female and approximately 46% are foreign born. According to estimates from Pew Research Center (Passel & Cohn, 2016), almost half of all foreign-born domestic workers are unauthorized immigrants.

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<sup>20</sup> Estimated expenditures on child-care, both inside and outside of the home, amounted to \$14.9 billion in 2015. The CEX last broke down separate estimates for child care expenditures inside and outside of the home in 2012. In that year, babysitting, nanny services, or child care inside the home accounted for almost 64% of the combined expenditures inside and outside of the home. Applying this percentage to combined estimated child care expenditures of \$14.9 billion in 2015 yields \$9.4 billion in estimated expenditures on care inside the home.

**Table 11: Demographic Characteristics, Private Household Workers Over Age 17, 2015**

<b>Gender</b>	Percent Female	92.6
<b>Race</b>	Percent White Only	82.0
	Percent Black Only	9.3
<b>Nativity</b>	Percent Foreign Born	45.7
<b>Age</b>	Mean Age	42

## 10. Closing the Nanny Tax gap

Most people devote substantial time and effort to hiring the right person to come into their home and look after their children, care for an aging parent, or clean their house. They prepare job descriptions, search for leads on potential job candidates, solicit and review applications, conduct interviews, check references, and carry out background checks all in an effort to determine whether a prospective employee is likely to be capable, trustworthy, and responsible. Yet relatively few put similar effort into researching their own responsibilities as household employers. In this section, we discuss measures that the IRS should undertake to encourage household employers to begin minding the Nanny Tax and their employees to comply with their income tax obligations.

### 10.1 *Informational barriers to compliance*

One barrier to compliance is that many household employers are blissfully ignorant of their Nanny Tax responsibilities. As a consequence, they often misunderstand the rules regarding whether a worker is an employee or an independent contractor as well as the regulations concerning the employment of unauthorized immigrants. These immigrants, themselves, often misperceive that filing and paying income taxes on their earnings will result in an immigration enforcement response. All of these misperceptions contribute to the tax compliance problem.

### **Misconceptions regarding employment status**

Frequently, employers mistakenly assume that their domestic workers are self-employed independent contractors and that they therefore have no responsibility to file information returns or collect and remit payroll taxes on their behalf. Many domestic employees also incorrectly assume that they are self-employed, although they may not fully understand or fulfill the tax requirements that accompany self-employment status. In fact, over 60% of the workers that have been classified as private household employees in the 2015 American Community Survey have actually identified themselves as self-employed.

Much of this confusion is attributable to the lack of clear and well-publicized guidelines. Although portions of the available IRS publications on household employment are sufficiently clear to dispel some common misconceptions regarding employer and employee rights and responsibilities, other portions are so vaguely written that even a highly compliance-oriented individual might come to the wrong conclusion about whether a household worker is actually an employee. Consider, for example, the guidance provided in the IRS bulletin for Tax Topic Number 756 (*Employment Taxes for Household Employees*) that is provided on its website (Internal Revenue Service, 2018b). The first portion of this document addresses the distinction between a household employee and an independent contractor:

“Household employees include housekeepers, maids, babysitters, gardeners, and others who work in or around your private residence as your employee. Repairmen, plumbers, contractors, and other business people who provide their services as independent contractors, are not your employees. Household workers are your employees if you can control not only the work they do but also how they do it.”

One might (correctly) reason from this brief description that, since domestic workers who are hired by a homeowner are generally subject to the homeowner’s supervision and guidance, they should in most cases be classified as employees. However, some household employers who give their domestic workers relatively free reign in performing their duties might be led to conclude from this brief description that their workers are not employees, but are instead self-employed independent contractors. Surprisingly, this is the full extent of the guidance that is provided in this tax topic bulletin on this vital and commonly misunderstood issue. Even more remarkably, the reader is not even referred to another information source for further details on

how to effectively apply this principle to conclusively determine whether a household worker is actually an employee.<sup>21</sup>

A somewhat more detailed, but still inadequate, treatment of this issue is provided in IRS Publication 926 (*Household Employer's Tax Guide*; IRS, 2018a). To the IRS' credit, this publication does address several common misconceptions regarding the employment status of domestic workers. For instance, it clarifies that the Nanny Tax applies to part-time as well as full-time employees, and it remains applicable regardless of the terms of payment (hourly, daily, weekly, or by the job). When employers hire their caregivers through an agency, they sometimes incorrectly assume that the agency will serve as the employer. While some home care agencies do actually oversee caregivers and act as their direct employers, the services of many placement agencies and registries are limited to referrals and other non-supervisory tasks (such as background screening). In such cases, the household serves as the direct employer of the caregiver, not the placement agency or registry. Publication 926 properly cautions that one may have a Nanny Tax responsibility even if the domestic worker was hired through an agency or a list provided by an agency or association.

Unfortunately, Publication 926 is much less definitive when it comes to explaining how one can distinguish a household employee from an independent contractor. While it does provide some clarity with respect to a couple of common household employment situations, it fails to resolve ambiguity and confusion in many others. As with the *Employment Taxes for Household Employees* bulletin, Publication 926 emphasizes the common law principle that a domestic worker is one's employee if "you can control not only what work is done, but how it is done" (p. 3). However, this publication goes a bit further by also illustrating the application of this principle to a couple of hypothetical scenarios. One scenario concerns a household worker who performs both babysitting and light housework services. In this scenario, the worker is provided with specific instructions on how to perform her duties as well as equipment and supplies to do the work. This combined provision of specific instructions, equipment, and supplies by the employer is presented as evidence of control over both what work is to be performed and how it is to be performed. The worker in this scenario is therefore identified as a household employee. While this example is adequate to clarify the employment status of many typical caregivers that are hired by households, it does not resolve the uncertainty regarding employment status in many other cases. For instance, suppose that the worker in this

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<sup>21</sup> The remainder of this IRS tax topic bulletin covers the filing and remittance responsibilities of household employers, which presumably will be read only if the employer has concluded that its domestic worker is actually an employee. In these sections, the reader is referred to Publication 926 and certain other IRS publications for additional details on these requirements. However, it is a rather remarkable oversight that a similar reference to a more detailed information source is not provided in the portion of the bulletin that concerns the vital issue of employment status.

example was not asked to do any babysitting but just light housekeeping. If the housekeeper brought her own equipment (vacuum, cleaning supplies, etc.) and only received limited instructions about what was needed, would this be sufficient to classify her as self-employed? What if we were to change this example so that she used the homeowner's vacuum but brought her own cleaning supplies? Does the vacuum alone imply that she is an employee? One cannot be sure based on the information provided.

As an illustration of a household worker that is not an employee, Publication 926 introduces a second scenario involving an individual who operates a lawn care business and offers his services to the general public. This individual provides his own tools and supplies, and he hires helpers to assist with the work. In this case we learn that neither this individual nor his helpers are household employees. Although this example clarifies employment status under a fairly typical lawn service situation, it does little to remove uncertainty regarding other common situations. For instance, suppose that the lawn care provider did not hire additional helpers, would he still be an independent contractor? How about if he provided his own gas and oil but used the homeowner's lawnmower or blower? One cannot be sure based on the information that has been provided.

Those who remain confused about what constitutes an employer-employee relationship after reading Publication 926 are referred to sections 1 and 2 of IRS Publication 15-A (*Supplemental Employer's Tax Guide*, IRS, 2017a). In Section 1 of this guide, we learn that it does not matter whether you actually control how the work is done, so long as you have a right to do so:

“An individual is generally your employee if you have the right to control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed.” (p. 5)

This is an important distinction, because it means that a domestic worker is deemed to be an employee so long as one has the authority to give explicit instructions, regardless of whether any explicit instructions are actually provided. The failure to explain this distinction in the previously discussed tax publications could lead some household employers to wrongly assume that their domestic helpers are independent contractors; consider, for instance, the aforementioned example of household employers who elect to give their domestic workers relatively free reign in carrying out their duties.

Section 2 of this supplemental guide describes various factors that should be taken into account when assessing the degree to which a worker is subject to behavioral control (such as

whether the worker is told what tools to use or what hours to work) or financial control (such as whether the worker has made a significant investment in tools and equipment or has an opportunity to realize a profit). In addition, there is a discussion of relevant indicators of the type of relationship between the parties, such as the presence of a contract that specifies the terms of the relationship, the presence of employee-type benefits (such as sick pay or vacation pay), or whether the engagement is for a specified period or indefinite. To illustrate how to apply these factors to assess whether a worker is an employee, a number of examples are provided. Notably, however, not a single one of them concerns the case of a domestic worker. Moreover, the limited discussion of the presence of a contract as a relevant factor in assessing employment status might feed into the commonly held misconception that a household employer can legally dodge the Nanny Tax simply by executing a contract that designates the employee as an independent contractor. Therefore, even this more detailed publication falls short of providing household employers with clear and adequate guidance regarding what constitutes an employer-employee relationship.

From the perspective of the IRS, it seems as though the employment status of domestic workers actually has been a largely settled issue for quite some time. For instance, during the Congressional hearings that led to the introduction of Schedule H (Proposals to simplify, 1993), Maurice Washburn, the Compliance 2000 Executive of the IRS at that time, testified that domestic workers are almost always employees of the person in whose home they perform services, because that person “almost invariably” has the right to direct and control the performance of those services (p. 38). The one exception he notes is when a business organization, such as a commercial housecleaning company, has the right to direct and control how the services are carried out, in which case the housecleaning company is the employer, not the homeowner. Observe that the domestic worker is classified as an employee under both of these scenarios, not as an independent contractor. Assuming that this continues to be the position of the IRS today, it is puzzling that this position is not plainly stated in the IRS publications on this topic. The failure of the IRS to stake out a clear position on the employment status of household workers in its publications invites confusion and contributes to the ongoing compliance problems.

The IRS does offer one way to obtain clarity on a domestic worker’s employment status. Either the household employer or the worker can file IRS Form SS-8 (*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*) to request a determination of the worker’s employment status. Unfortunately, however, this form was designed rather generically in the context of a firm that hires a worker, which makes it rather confusing for households and domestic workers to complete. In addition, a filer can expect it to take at least six months before a determination is provided by the IRS (Internal Revenue Service, 2017b). Still, this is a valuable service that many household employers and domestic

workers could benefit from. However, the IRS does not publicize its availability in the *Employment Taxes for Household Employees* bulletin or even in Publication 926, which are the two main publications that focus on household employment. (There is, at least, a brief mention of the service on p. 8 of the *Supplemental Employer's Tax Guide*). Of course, many household employers and employees would not have any need for this service in the first place if these publications were revised to provide clearer guidance on this issue.

### **Misunderstanding of regulations concerning unauthorized immigrants**

Beyond the misconceptions regarding the employment status of household workers, there is also substantial confusion surrounding the employment of unauthorized immigrants. Unauthorized immigrants are estimated to represent only about 5% of the overall U.S. workforce, but they account for approximately 22% of all private household workers (Passel & Cohn, 2016), which means that the household workplace is an area where all of the various labor market and social issues surrounding the topic of illegal immigration come to a head. Many household employers rely on a “don’t ask, don’t tell” policy when hiring unauthorized immigrants, hoping that ignorance of their work authorization status will shield them from any legal repercussions. In fact, though, household employers are legally obliged to verify a prospective employee’s eligibility to work and to complete USCIS Form I-9 (*Employer Eligibility Verification*) prior to making a hire.<sup>22</sup> As for household employers who do knowingly hire unauthorized domestic workers, there is often a misconception that the lack of legal work authorization exempts them from payroll tax requirements.

Many unauthorized immigrants fear that the payment of income and payroll taxes will trigger an immigration enforcement response. In fact, though, the IRS maintains the confidentiality of taxpayer records and issues Individual Taxpayer Identification Numbers (ITINs) to undocumented workers upon request in order to facilitate the filing and payment of taxes. Although unauthorized immigrants are not eligible for many social and tax-related benefits, such as Medicare, Social Security, or the Earned Income Credit, tax records provide documentation of their earnings history, which is needed when attempting to rent an apartment, purchase a car, qualify for a mortgage, or secure a personal loan. In addition, if a previously unauthorized worker later receives work authorization and is issued a Social Security Number, that worker can receive credit for the past Social Security contributions that were made during the period of unauthorized employment. Furthermore, should an unauthorized immigrant find herself before an immigration judge, a history of filing and paying taxes may improve the chances of a favorable adjudication (Blanco, 2017).

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<sup>22</sup> These requirements are clearly explained in Publication 926 IRS (2018b, p. 3); however, employers of potentially unauthorized immigrants may not be inclined to seek out published guidance on this issue.

### 10.2 Addressing the knowledge gap

Clearly, then, the Nanny Tax gap is partly attributable to a knowledge gap. The IRS can help to close this knowledge gap by devoting more resources towards educating household employers and their employees about their rights and responsibilities. Much as the IRS has done for other tax issues associated with substantial compliance problems, such as the Earned Income Credit, it should engage in:

- Targeted information campaigns;
- Community outreach efforts; and
- Partnerships with other stakeholders, including tax preparers, state revenue administrations, and household employee advocacy groups.

These educational efforts should address confusion regarding independent contractor status, the importance of Social Security, Medicare, and unemployment benefits to domestic workers, employer payroll tax and information reporting responsibilities, employee income tax reporting obligations, and the risks and penalties associated with noncompliance.

IRS publications on household employment should also be revised to more plainly state the Agency's position on the circumstances under which domestic workers are deemed to be household employees. Beyond improving these publications, the IRS should introduce an online application similar to the "employee/contractor decision tool" that the Australian Taxation Office makes available to its taxpayers (see <https://www.ato.gov.au/calculators-and-tools/employee-or-contractor/>). This easy-to-use application takes the user through a series of questions that lead to a clear determination of whether a worker is an employee or an independent contractor. Provided that the user has given accurate responses to the questions, the user can then rely on this determination for tax purposes. A record of the responses and the resulting determination can be downloaded by the user to demonstrate due diligence in the event of an audit. Such an application would be relatively inexpensive for the IRS to develop and maintain, and it would serve as a fast, easy, and immensely helpful means for household employers and domestic workers to resolve their uncertainty over the employee-independent contractor issue.

As discussed previously in Subsection 10.1, the IRS position on household workers that was shared during the 1993 Congressional hearings on the Nanny Tax was that these workers are almost always employees of the person in whose home they perform services. Assuming that this remains the IRS position today, it should explore working with lawmakers to establish a rebuttable presumption that an employer-employee relationship exists when a household hires a worker to perform personal services in or around the home. The burden would then be placed on the household to rebut this classification, for instance by providing evidence that the

worker operates or is employed by a business that has the right to control how the work is performed.

The proposed outreach efforts and information campaigns should highlight the legal requirement for household employers to verify work authorization status and the potentially severe consequences for noncompliance. To the extent that household employers continue to employ unauthorized immigrants, it is important to reassure undocumented workers that filing an income tax return will not result in an immigration enforcement response and to inform them of the various benefits of establishing a tax filing history and paying their share of taxes (building consumer credit, demonstration of law-abiding behavior to reduce the potential for deportation, etc.). The IRS should team with other stakeholders to develop and implement effective strategies for outreach and information dissemination.

### **10.3 *Reducing compliance burdens and increasing enforcement***

Of course, the Nanny Tax gap is not entirely attributable to a knowledge gap. Many household employers are aware of their payroll tax responsibilities but choose not to comply, either because they feel that federal and state filing and remittance requirements are too burdensome or because they simply do not want to bear the added expense associated with federal and state payroll taxes. The introduction of Schedule H in 1995 did simplify compliance with federal Nanny Tax requirements to some degree. However, it did nothing to address the state-level Nanny Tax compliance burden. It would certainly be desirable for the federal and state tax administrations to explore ways to coordinate and simplify the overall compliance process. As just one example, the payroll tax reporting burden among household employers of unauthorized immigrants could be greatly simplified if the process for reporting their earnings on state and federal payroll returns was aligned.

At the same time, enhanced enforcement of payroll tax filing and remittance requirements is needed to transform the current culture of Nanny Tax noncompliance into one of compliance. Presently, even rather thorough tax audits, such as those conducted under the IRS National Research Program (NRP), fail to uncover most instances of Nanny Tax evasion. Under the NRP, a large stratified random sample of federal individual income taxpayers is audited for a given tax year. One of the purposes of this program is to measure the magnitude of tax noncompliance in the overall population with respect to the various income, deduction, and credit items on the tax return. Haskins (2010) reports that NRP audits conducted under the tax year 2001 program only succeeded in identifying a handful of household employers that had failed to file Schedule H. In fact, if one were to rely on the evidence from these audits, one would mistakenly infer that more than 98% of all required Nanny Taxes were duly reported in that year.

Clearly, even these rather thorough audits that are specifically designed to measure noncompliance are not up to the task when it comes to Nanny Tax evasion. The IRS needs to develop more effective methods to probe for the presence of domestic workers and to apply these methods more routinely, especially when examining returns that fit the profile for Nanny Tax noncompliance; for instance, returns of dual-earner households that report dependent children but do not claim the Child and Dependent Care Credit. In short, what is needed is a well-designed “compliance campaign” along the lines of the tailored compliance campaigns that the IRS has begun rolling out to address specific large and international business compliance issues (Internal Revenue Service, 2017c). An important objective of this campaign should be to make the perceived risk of detection and punishment more salient among Nanny Tax evaders; until household employers perceive that Nanny Tax evasion will not be tolerated by the IRS, the current culture of noncompliance will persist.

Assuming that the IRS is successful in substantially improving compliance among household employers, this should help to promote greater compliance among their domestic employees as well. Once a W-2 form has been issued and payroll taxes have been reported, domestic employees have a strong incentive to file an income tax return and properly report their earnings. On the other hand, it is not always the employer that drives the compliance decision; household workers sometimes insist on being paid under the table. Therefore, an effective compliance campaign must focus on promoting buy-in among domestic workers as well as household employers.

Sometimes amnesties are introduced prior to the execution of a new compliance program in order to provide noncompliant taxpayers with an opportunity to “get right” with the tax administration before they find themselves subject to stiff penalties and fines under the new regime. The IRS should consider offering an amnesty prior to the launch of a Nanny Tax compliance campaign as a potential way to encourage Nanny Tax evaders to come forward voluntarily and to ease the transition process.

Normally, employers are required to withhold income taxes from employee earnings. This measure was introduced during World War II as a means to promote the efficient collection of revenue following the massive expansion of income taxation to fund the war effort (Higgs, 2007). Since that time, it has proven to be a very effective way to ensure tax compliance. The IRS estimates that 99 percent of all wages are properly reported by filers of individual income tax returns (Internal Revenue Service, 2016). Under the current Nanny Tax regulations, however, household employers are not required to withhold income taxes from their employees’ pay. When taxes on one’s earnings are not withheld, compliance-minded taxpayers face the prospect of having to make regular estimated tax payments on their own or else risk experiencing hefty tax obligations (and, potentially late-payment penalties) that they

## Who is Minding the Nanny Tax?

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may not be equipped to pay when they file their taxes in the following year. Lawmakers should consider making the withholding of income taxes mandatory for household employers, just as it is for other employers. Although this would increase the compliance burden for household employers to some degree, it would reduce the compliance burden for their employees and promote compliance with their income tax obligations.

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