Nanny Tax Evasion Grows Bigger and Bigger

By David Cay Johnston

David Cay Johnston is a former tax reporter for *The New York Times* and teaches at Syracuse University Law School. He is also the author of two books about taxes, *Free Lunch* and *Perfectly Legal*.

Johnston critiques new research into why household employment tax evasion is getting worse and takes a look at the latest development in refund anticipation loans.

The new healthcare law's requirement that companies report payments to vendors of $600 or more has become the latest weapon in the fight against tax complexity. Never mind that payments to individuals of this amount must be reported or that the information is already in accounting records. This is a bipartisan cause.

But what about real complexity issues — like the nanny tax?

While we tend to think of tax planning as the province of the rich and large businesses, nannies and maids are affected by tax planning, too, although because they are not known for their campaign donations their concerns get no official attention.

From the point of view of servants, the tax code, the way it is administered, and societal norms all tend to worsen their circumstances, not improve them. For their employers, the lack of enforcement makes tax evasion profitable.

Just how the law, its enforcement, and societal behavior combine to the detriment of household workers is the subject of a fascinating new thesis by Catherine B. Haskins, who earned her doctorate in economics this spring from the University of Massachusetts at Amherst. (For the thesis, see *Doc 2010-17795*.)

Haskins has opened a whole new window on tax compliance, the distribution of burdens, and how needless complexity creates silent suffering among those without lawmakers on speed dial.

Haskins's work builds on a groundbreaking 1974 paper by Shlomo Yitzhaki which showed that tax compliance increases when the penalties for those who get caught are based not on unreported income, but on the tax avoided. A system with progressive rates using tax, rather than income, as the base for imposing penalties raises the cost of getting caught and thus encourages compliance. Funny how that insight has been ignored in most of the literature on tax enforcement — other than by serious scholars like James Andreoni, Brian Erard, and Jonathan Feinstein, whose "Tax Compliance" in the June 1998 *Journal of Economic Literature* is a classic.

When it comes to compliance, the nanny tax is the opposite side of the coin from wages and salaries. The IRS estimates that 99 percent of wages reported by employers turn up on income tax returns thanks to third-party reporting.

But what of caregivers at home for children and disabled adults? And what of housekeepers, maids, gardeners, and drivers? The vast majority of servants do not earn Social Security credits, which means they will get less or, under a Reagan-era change, nothing in old age.

Fred Goldberg, a former IRS commissioner, estimated in 1995 that 2 million households employed legal domestic help, four times as many as filed Schedule H to report the pay and payroll taxes of their servants. (For prior coverage, see *Tax Notes*, Nov. 6, 1995, p. 755, or *95 TNT 215-44*.)

Add in people illegally in this country — and likely to earn the lowest wages because they can be easily exploited with threats of deportation — and the evasion rate would have been higher then and would be even higher now.

The phrase "nanny tax" made it into the popular lexicon back in 1993 when Zoe Baird, President Clinton's first choice for attorney general, withdrew her nomination because she employed illegal immigrants as servants and failed to cover their payroll taxes. Judge Kimba Wood's nomination also foundered, even though she filed and paid. Her children's nanny was in the country illegally, although employing her was not a crime. Still, it was enough to leave us with the childless Janet Reno running the Justice Department.

The next year Congress revised the nanny tax law, its sponsors crowing about how reform would make it easier to report and remit payroll taxes on servants. So what happened?

Schedule H filings in 1994 totaled almost 500,000. In 1995, in announcing the supposedly simplified Schedule H, the IRS said it anticipated that about 720,000 taxpayers would use the form. Fewer than half as many did. (For prior coverage, see *Tax Notes*, Aug. 14, 1995, p. 807.)

Since then the number of Schedule Hs filed has slid downward. In 2008 it was down to 219,000 or about 1 in 650 tax returns.

So have servants become a rarity in America, employed by just 0.15 percent of taxpayers? Or is something else going on? Haskins shows there are many forces at work in the increasing levels of nanny tax evasion, which in turn reduce the old-age incomes of servants, especially women.

One is the 1994 simplification law. It made calculating, filing, and remitting payroll taxes on servants about as short and simple as that five-syllable word: simplification.

Carl Nilson

Catherine B. Haskins made a groundbreaking study of the reasons behind widespread evasion of the so-called nanny tax to earn a doctorate in economics from U-Mass Amherst.

If the new healthcare law requiring reporting vendor payments of $600 or more — data already collected for bookkeeping, usually in digital format — is a monstrous and unreasonable burden, then how about calculating the taxes to be withheld from the pay of domestic servants, including state taxes and the annoyingly complex unemployment levies?

Haskins did much more than analyze the very limited tax data the IRS made available to her. She also interviewed 30 people who hired domestic help. Because some of her subjects were married couples, her sample covered 24 households. And she interviewed 30 maids, all Filipinos legally in the United States, none of whom worked for the 24 employers she interviewed.

The 60 interview subjects all lived in an affluent area of Washington. That may distort her findings. A 2005 study by Kim Bloomquist and Zhiyong An, which launched Haskins on her project, found that people in Washington are six times more likely than Americans overall to file a Schedule H on payroll taxes for their nannies, maids, drivers, gardeners, and other domestic servants.

Haskins noted that traditional models of taxpayer behavior consider evasion risky. Not so for nanny tax evasion. The chance of detection is virtually nonexistent except for one class of Americans: those hoping to get an appointment to a sensitive government post, be it as a lowly IRS clerk or in the president's Cabinet.

Overall, those who employ servants are better off, older, and more likely to be married than typical taxpayers, Haskins showed from data the IRS gave her:

Characteristic	All Taxpayers	Schedule H Filers
Age 65+	12.9%	37.3%
Married Filing Jointly	38.6%	70.3%
AGI $150,000+	5.2%	65.3%
Child At-Home Exemptions	33.6%	48.1%
Child/Dependent Care Credit	4.8%	22.7%

One of her most curious findings is that the greatest amount of detected nanny tax evasion is among those making less than $31,000 annually.

One obvious explanation for this is that people with lower incomes may believe they cannot bear the tax. But her thesis misses another possible explanation involving how separated and divorced couples with children handle their finances: divorce tax planning.

Child support payments are not taxable to the receiving spouse. If the spouse who moves out pays the mortgage and property taxes (and reaps the income tax deductions), the economic income of the spouse who files as head of household is higher than what shows up on tax returns. Arranging finances to concentrate tax benefits for the higher-earning parent is a common practice, as is retaining an existing house to avoid sale, moving, and repurchase expenses.

Haskins made another truly astonishing find. In 2001 the IRS's carefully crafted National Research Program study of almost 45,000 tax returns found almost $12 million of nanny taxes being owed, but also resulted in nearly $11 million being refunded to people who either paid too much or had no obligation to pay. Haskins wrote that "this statistic alone confirms" what the 60 interview subjects told her: "Many filers don't fully understand the law."

She also found that a fourth of nanny tax filers in 2006 paid less than $4,000 to their servants, meaning their tax liability was well under $1,000 each, while at the other end she found 4,242 returns reporting $25,000 or more of nanny tax. So more than 2 percent of Schedule Hs are filed by people with a personal payroll of more than $200,000 for servants.

The implication is that very rich people who have a large retinue of servants and assistants — Sens. John McCain, R-Ariz., and John F. Kerry, D-Mass., among them — tend to comply because they have a formal payroll system, while those with a weekly maid find the calculations and forms just too much trouble to be worth the bother.

Prof. Richard B. Malamud, who teaches federal income taxation at California State University Dominguez Hills, wrote a 1996 *Tax Notes* report on the nanny tax. He told me that the complaint about the added burden of the healthcare reporting requirement is overblown, something my sons who run our lodging management business also tell me.

But the burdens of the nanny tax are real, legitimate, and corrosive, Malamud said. His suggestion then and now is to simplify it by treating domestic servants as independent contractors, requiring only withholding of the employer's side of the payroll tax. (For the special report, see *Tax Notes*, Mar. 4, 1996, p. 1401, *Doc 96-6389*, or *96 TNT 46-60*.)

There are some logical reasons, beyond lawbreaking, that explain the nearly 60 percent decline in nanny tax filings.

First is the use of day care outside the home instead of au pairs and nannies. Most American housing built since 1900 is not designed for servants living under the same roof, and devices like the flexible dependent-care spending account make outsourcing to a day-care center easy.

Second, it is easy to help a maid, grass cutter, or gardener set herself up as a business or only retain those who do. Vendors who are organized as businesses are not subject to the nanny tax. That is what our weekly housekeeper did years ago, converting from being a maid to a maid service.

So here is a suggestion for both the Statistics of Income economists and the Treasury Inspector General for Tax Administration: Analyze the data on how many housekeepers, caregivers, and other domestic servants have set themselves up as corporations, limited liability companies, or some other entity, and then check *their* tax returns.

Third, many accountants and return preparers tell clients to ignore the law and regard a directly hired, but once-a-week or less housekeeper as an independent contractor because she has multiple employers. Given the utter lack of enforcement of the rules, the risks of detection, pursuit, and payment of penalties are on a par with winning the Powerball lottery or dying in a jetliner crash.

Haskins's thesis should serve as the basis for a wholesale rewrite of the nanny tax law and a redesign of the awful Schedule H. Given the political influence of paid domestic caregivers and maids, and the prospect that a simplified regime would increase the number of nanny taxpayers at least tenfold, however, the chances of actual reform are about on a par with getting caught cheating on the nanny tax.

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On another note, IRS Commissioner Douglas Shulman announced August 5 that the Service would stop helping usurious lenders by issuing the "debt indicator", which told lenders whether a requested refund is likely to be issued.

Three cheers for Shulman and for the dedicated consumer advocates who have fought for years to stop the abusive refund anticipation loan business, which diverts to bankers large sums from the earned income tax credit and other benefits intended to help the working poor.

Shares of H&R Block fell about 4 percent on a sharp rise in volume the day of the announcement. Shares of Jackson-Hewitt fell much more, dropping 23 percent on the news.

Alan Bennett, H&R Block's CEO, said that the IRS had taken away "an essential underwriting tool banks use when considering whether to loan money to clients" that "will likely increase the cost of refund anticipation loans for millions of low- to moderate-income taxpayers."

Bennett said H&R Block's "real concern is how the increased lending risk will potentially hurt consumers with significantly lower loan approval rates and higher costs for the most vulnerable taxpayers."

His statement is nonsense. Bennett's fiduciary duty is to his shareholders, not the working poor. His job is to maximize profits. His board clearly wants him to do all he can to squeeze the vulnerable and economically foolish. The invisible hand of the government giving H&R Block access to what should be taxpayer secrets via the debt indicator helps extract these fees from those "vulnerable taxpayers."

Nine years ago, when Mark Ernst was H&R Block's CEO, he said technology would soon enable the IRS to issue refunds in 72 hours or less. "That will reduce or eliminate the need for refund anticipation loans, a product that has hurt our industry's reputation even as it met consumer desires," Ernst said. "That's a development we should prepare for — and one we at H&R welcome." (For prior coverage, see *Tax Notes*, May 28, 2001, p. 1503, *Doc 2001-15064*, or *2001 TNT 103-2*.)

Ernst no longer runs H&R Block. In May, in his new role as an IRS deputy commissioner, he said a federal working group examining RALs observed that consumers were not sensitive to RAL pricing. Why? A lack of transparency about loan fees combined with a seemingly "painless choice" to pay the fees from a refund rather than their own pockets. (For prior coverage, see *Tax Notes*, May 10, 2010, p. 630, *Doc 2010-10173*, or *2010 TNT 88-4*.)

RALs are not market capitalism, but a prime example of how corporate socialism relies on subtle subsidies, in this case the debt indicator, to redistribute money from those with less to the economic elite. J.P. Morgan Chase announced this year that it would no longer participate in this exploitative business. That H&R Block remains fully committed to extracting every last cent from what its CEO calls "vulnerable taxpayers" should be a source of shame in Kansas City, where usurious fees extracted from the working poor helped cofounder Henry Bloch acquire the wealth to have a business school named after him as well as a $95 million building stuffed with modern and African art at the Nelson-Atkins Museum.

Your thoughts? Email me at *JohnstonsTake@tax.org*.