

Net Pay Problems

The household employment industry is the only industry in America where a significant percentage of the labor force starts from a Net Pay and attempts to work backwards to arrive at the appropriate Gross Pay. This edition of *The Legal Review* delves into one of the many problems that can arise from this flawed approach to payroll.

The Mistake

A first-time household employer in Massachusetts hired a nanny after agreeing to pay her on a Net Pay ("take-home") basis. The nanny had asked for \$500 Net and the family agreed -- without really understanding what that meant financially or administratively. They wanted to make her happy and decided that everything else could be dealt with later.

They did not realize until it was too late that their Net Pay agreement was going to be a major nuisance in their employment relationship.

The Law

Payroll is calculated, tracked and reported to the tax authorities on a Gross Pay (before taxes) basis. In the eyes of the law, there is no such thing as a Net Pay compensation arrangement.

Employers are required to have employees fill out Form W-4(s) to elect the withholding status that most accurately reflects their life situation in order to pre-pay taxes each pay period at a rate that will ***approximately*** cover their end-of-year tax liability. It is the employee's obligation to make appropriate elections on Form W-4 and weigh the other factors that might influence their tax liability (i.e. other income, investment dividends, deductions, tax credits, etc.). If an employee under-withholds, they have to make a tax payment at year end. On the other hand, if they over-withhold, they will get a tax refund at year end. Either way, it has no impact whatsoever on the employer.

The employer's obligation is simply to withhold the appropriate amount of taxes from the gross pay -- based on the employee's Form W-4 elections. Those gross wages -- and the corresponding employee and employer taxes -- must be reported and remitted to the appropriate state and federal tax agencies.

The Problem

Because the income tax withholding process is based on Form W-4's **approximate** tax rate - and it's subject to changing laws and shifting tax tables - "grossing up" a Net payroll is an administrative nightmare for families and extremely prone to error.

In addition, the employee's withholding elections actually caused the family's cost to increase substantially. This illustration explains the financial issues with a Net Pay arrangement:

The nanny is single with no children. Using the Form W-4 worksheet, the withholding election that best fits her life situation is **Single With 2 Allowances**. In that case, the Gross Pay would need to be \$617 per week in order for the nanny to take home \$500 per week. The employer taxes are calculated on the Gross Pay, so in this case, they would be another \$56 per week. The total family cost (before tax breaks) is \$673.

However, the nanny filled out Form W-4 as **Single With 0 Allowances**. This election meant the Gross Pay would jump to \$653 per week. Based on that higher Gross Pay, the employer taxes increased to \$59 per week, making the total family cost (before tax breaks) \$712.

This \$39 difference each week amounted to \$2,028 over the course of the year.

The family did not mind paying the extra amount because, in their minds, they were helping the nanny cover her tax obligation. However, when the nanny did her tax return at the end of the year, she got a refund of almost \$2,500. The family got our name from a friend who uses our service. They called and asked how something like this could happen. We explained the inherent issues with "grossing up" a Net Pay.

Once they understood the situation, they felt that the nanny had taken advantage of their generosity. They had agreed to cover her taxes, but they did not agree to over-pay her taxes so she could get a large bonus at the end of the year.

To add insult to injury, when they joined our service we found numerous errors in their "gross up" calculations due to changing tax tables during the year. Tax reductions during the year (designed to stimulate the economy) lead to miscalculations and the need to amend their employment tax returns.

The Outcome

The family strongly hinted that the tax refund money belonged to them, but the nanny did not take the hint and never offered to reimburse the family. Resentment and animosity gradually increased. When the family found out that the employee portion of Social Security was being reduced in 2011, they called us to re-calculate the Gross Pay accordingly. The nanny distrusted the family at this point and balked at the reduction because she sensed that the family was trying to eliminate her year-end tax refund.

The distrust and resentment led to a termination and the family is currently looking for

another nanny.

How It Could Have Been Avoided

A little knowledge by all parties during the original compensation discussion would have prevented all the mistakes and distrust. Knowing what they know now, the family is prepared to simply offer a legal Gross Pay and let the new nanny be in charge of her own tax liability/refund at year end. In addition to saving money, the family will eliminate a lot of math homework and tax table monitoring every payday.

At Breedlove & Associates, we take great pride in providing free education and advice during the employment process -- so that families don't have to worry about time-consuming and expensive problems. For personalized assistance and guidance, just give us a call Mon-Fri 8am-6pm Central Time or watch our brief [video tour](#). We're here to help.

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