

PROTECTING THE HAND THAT ROCKS THE CRADLE: ENSURING THE DELIVERY OF WORK RELATED BENEFITS TO CHILD CARE WORKERS

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INTRODUCTION

Illegal child care has taken a center stage as the nanny tax trap has snared politicians,¹ political appointees,² and candidates for political office.³ Media attention given to the nanny tax scandals raised public awareness and stimulated debate on issues ranging from finding qualified in-home child care providers and

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1. White House lawyer William Kennedy was stripped of his duties overseeing background checks of administrative employees after it was discovered that he attempted to conceal the fact that he had not paid taxes for a nanny employed by his family. See Douglas Jehl, *White House Aid Who Failed to Pay a Tax Is Punished*, N.Y. TIMES, Mar. 21, 1998, at 1.

2. Zoe Baird and Kimba Woods both withdrew their nominations for attorney general after allegations surfaced that they had hired illegal domestic workers. The focus on non-critical issues such as Nannygate has disqualified excellent candidates such as Baird and Woods, depriving the nation of their service. See STEPHEN CARTER, *THE CONFIRMATION MESS: CLEANING UP THE FEDERAL APPOINTMENTS PROCESS* (1994). Janet Reno, a single woman with no children, was later confirmed as the nation's first woman attorney general.

3. In California, the 1994 Michael Huffington-Diane Feinstein senatorial race was plagued with nanny tax allegations. First, it was discovered that Huffington had employed an illegal immigrant to work in his home as a housekeeper/nanny for more than four years. In an advertising campaign, Huffington accused Feinstein of also employing an illegal housekeeper. Feinstein countered that she had hired the woman long before enactment of the 1986 federal law that made it a crime to hire illegal workers, had checked the woman's visa to verify her employment status, and had paid all of the required employment taxes. Feinstein claimed that she was unaware that the woman's visa was valid for only one year and was conditional on her employment at the Guatemalan Consulate in San Francisco. The INS later verified Feinstein's story, stating that the employee did have a valid visa and that only an expert would be able to detect the employment limitations. While Feinstein's defense upheld public scrutiny Huffington did not fare as well. Days after a local television station poll showed Huffington with a two-point lead, another station released a poll showing Feinstein with a 16-point lead over Huffington, up 10 points from a poll taken two weeks earlier. The station attributed Huffington's drop in the polls to his disclosure about employing the illegal worker. See Patrick J. McDonnell et al., *Feinstein Worker Entered U.S. Legally, but Visa Lapsed Politics: INS Records Indicate No Violation of Federal Law*, L.A. TIMES, Nov. 5, 1994, at A1.

During the 1998 California gubernatorial primary race, allegations resurfaced that Representative Jane Harman broke the law by hiring an illegal nanny. The allegations first became public when Harman voluntarily disclosed the information in defense of Zoe Baird and Kimba Woods. Harman lost the primary to challenger Grey Davis, who was later elected Governor of California. *Nanny Allegations Resurface*, CONGRESS DAILY, Apr. 27, 1998.

the child care demands of women in the work force, to the archaic and confusing legal requirements associated with the payment of employment taxes for household employees.⁴ Child care issues also received unprecedented attention in the political dialogue.⁵ Congressional consideration of the nanny tax compliance problem prompted legislative simplification of the employment tax reporting requirements for household employees.⁶

The payment of employment taxes by household employers is only half of the issue. The political rhetoric has ignored the effects of noncompliance on household employees. Some laborers have jobs paying less than the minimum wage, and they receive no overtime or health care benefits. These workers, who are predominantly women, will be unable to receive social security benefits upon retirement, unemployment benefits if they are suddenly discharged, or disability benefits in case of illness or accident.

Many in-home child care providers endure third-world working conditions. The images of illegal immigrant workers, who toil in the soil, digging and picking the fruits of our agricultural labor, or work fourteen-hour days in sweatshops⁷ for little money and no benefits, spawn protests and boycotts.⁸ However, little consideration is given to the plight of workers, both legal and illegal, who iron clothes, scrub floors, and change diapers every day in numerous American homes. These workers provide services subordinate to other wage laborers with respect to status, salary, and opportunities for advancement. Their average yearly income barely exceeds the poverty line. And they are virtually all women.

In our own employment relationships we may be in a position to bargain for decent wages, medical benefits, educational assistance,⁹ and other accouterments

4. See Rochelle L. Stanfield, *Child Care Quagmire*, NAT'L L.J., Feb. 27, 1993, at 512 (quoting Mary Whitebrook, Director of the Oakland-based Child Care Development Project, who commented that the scandal is helping to break the silence about the child care problem and raise the awareness of the public, policy-makers, and the media).

5. Senator Daniel Patrick Moynihan (D-NY) introduced a bill to reform the employment tax requirements. A similar bill was introduced in the House of Representatives by Andrew Jacobs, Jr. (D-IN).

6. Social Security Domestic Employment Reform Act of 1994, P.L. 103-387, 108 Stat. 4071 (1994). See *infra* notes 26-41 and accompanying text for a discussion of this act.

7. See Lora Jo Foo, *The Vulnerable and Exploitable Immigrant Workforce and the Need for Strengthening Worker Protective Legislation*, 103 YALE L.J. 2179, 2181 (1994) (citing U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO/HRD-88-130BR, "SWEATSHOPS" IN THE U.S.: OPINIONS ON THEIR EXTENT AND POSSIBLE ENFORCEMENT OPTIONS 16 (1988). A sweatshop is defined as "a business that regularly violates both wage or child labor laws and safety or health regulations.").

8. Activists targeted Nike and Disney with protests and boycotts following reports from the National Labor Committee that workers producing Nike shoes in Indonesia earn as little as two dollars per day and make as many as 100 shoes a day. Many of the workers are children, some as young as ten years old, and work up to 18 hours a day. See Diana Griego Erwin, *Children's Labor Cheapens Our Gifts*, SACRAMENTO BEE, Nov. 26, 1996, at B1.

9. IRC § 129 authorizes the establishment of employer educational assistance programs.

that middle class workers expect to receive in exchange for their labor. For a fortunate few, child care is part of the compensation package.¹⁰ When both parents work outside of the home, employer-provided child care is the ultimate perquisite.¹¹ Other hard working American families are faced with a dilemma: Who will mind the kids? Immediate and extended family members may not be available or reliable.¹² As the average work day increases, the eleven-hour daily schedule of most day care facilities may not provide adequate child care coverage. Reliable in-home child care is the only alternative for some working families.

As the cost of in-home child care increases, even families that can "afford" in-home child care struggle to pay the exorbitant salaries demanded by experienced nannies.¹³ Many nannies, however, will accept a lower fee on the condition that they are paid under the table to increase the amount of money they actually take home. Hiring an illegal immigrant child care provider presents another more affordable in-home child care option.¹⁴ Illegal immigrant child care providers are paid lower wages and will often work longer hours than their legal counterparts.¹⁵ In either case there is a great incentive to avoid federal laws that

Employees participating in an employer educational program may receive tax-free payments of tuition, books, and supplies worth up to \$5250. I.R.C. § 129 (West Supp. 1998). For further discussion of this section, see *infra* notes 130-35 and accompanying text.

10. See generally Christine A. Clark, *Review of Florida Legislation; Comment: Corporate Employee Child Care: Encouraging Business to Respond to a Crisis*, 15 FLA. ST. U. L. REV. 839 (1987). Professor Clark notes that employers have been slow in responding to the changing demographics of the work force and have failed to provide most working families with child care options. *Id.*

11. Day care has become a major workplace issue for working mothers. Only two percent of American employers provide their workers with day care. Employers providing day care tend to be large companies such as Motorola and Eli Lilly. See Kim Phillips, *The Parent Trap in These Times*, INST. FOR PUB. AFF., Feb. 1997.

12. See *id.* Many women are forced to rely on relatives for day care when no other options are affordable or available. However, friends and family members are notoriously unreliable. Even if keeping child care in the family provides the best environment for the child, many adult family members are working as well.

13. See *infra* notes 90-91 and accompanying text for a discussion of wages paid to experienced, educated nannies.

14. Throughout this Article, use of the term "illegal immigrant child care worker" is distinguished from "illegal child care worker." The author intends illegal immigrant child care worker to mean someone who is ineligible to work in the United States. Based on this definition, legal workers include workers with documentation of United States citizenship, lawful residence, or INS work authorization. When referring to an illegal child care worker, the author intends to include any worker who is a citizen, resident, or other individual who is authorized to work in the United States, but who fails to comply with federal and state employment tax laws or to report earned income.

15. See Kathleen A. Delaney, Note, *A Response to "Nannygate: Untangling U.S. Immigration Law to Enable American Parents to Hire Foreign Child Care Providers*, 70 IND. L.J.

require household employers to hire legal household workers and pay employment taxes.

The delivery of child care services results from the formation of a partnership between parents, private child care providers, and the public.¹⁶ The federal tax laws reign as the key element of the public paradigm.¹⁷ The provisions that command the payment of employment taxes are found in the Internal Revenue Code (the "IRC"),¹⁸ as is the child care tax credit,¹⁹ which provides a federal tax rebate for child care expenses. The child care credit is in fact the largest federal child care subsidy available to taxpayers with dependent children.²⁰

Reliance on limited tax credits to subsidize the cost of child care is symptomatic of a federal tax policy that provides rebates to taxpaying families but fails to consider the interests of child care providers. Federal child care tax expenditures, such as the child care credit, can be utilized to elevate the status of domestic work, allowing child care providers to achieve economic parity with other laborers. Advancements in the working conditions associated with in-home child care work will make domestic employment a more attractive employment option for women, particularly women who are re-entering the workforce after raising children of their own.

The failure to require household employers to establish legal employment relationships with child care providers devalues domestic work and produces adverse economic consequences that extend beyond the exploitation of any individual worker. Child care workers who do not receive wages and benefits necessary for their basic subsistence must rely on other sources of financial assistance. Ultimately the cost of supporting domestic workers and their families shifts to the public through government programs such as Medicaid, Aid to Families with Dependent Children ("AFDC"), and food stamps. The importance of these issues justifies the establishment of a federal tax policy that protects the interests of household employees and their families by shifting the economic burden of providing for these workers to the employers for whom they work. However, the tax code and its enforcers have done little to encourage household employers to pay employment taxes for their household employees.

The purpose of this Article is to explore why compliance with the federal domestic employment tax laws has decreased despite simplification of the

305, 314 (1994) (quoting Ellen Sehgal & Joyce Vialet, *Documenting the Undocumented: Data, Like Aliens, are Elusive*, MONTHLY LAB. REV., Oct. 1990 at 18, 20).

16. See Sharon C. Nantell, *The Tax Paradigm of Child Care: Shifting Attitudes Toward a Private/Public/Parental Alliance*, 80 MARQ. L. REV. 883 (1997). The author refers to the delivery of child care services to parents through private child care providers with federal subsidies. *Id.* at 907-09.

17. See *id.* at 909.

18. I.R.C. §§ 3101 (1994), 3102 (West Supp. 1998).

19. I.R.C. § 21 (West Supp. 1998). See *infra* notes 149-55 and accompanying text for a discussion of the child care credit requirements.

20. See Stanfield, *supra* note 4, at 512. It is estimated that 60% of the \$7 billion in federal child care subsidies paid in 1991 were paid through the child and dependent tax credit.

requirements for paying the tax.²¹ This Article examines noncompliance with the nanny tax by household employers and suggest proposals for change. The issues raised in this Article apply with equal force to all domestic employees who are denied the benefits afforded other paid laborers, not just nannies. However, establishing a policy to protect the rights of in-home child care providers is the specific focus of this Article because there are current tax provisions that grant tax incentives for child care expenditures.

The Article begins by providing background information on the nanny tax and its payment. In Part III, the Article considers non-compliance by household employers. This section suggests several reasons for tax avoidance by domestic employers, including: the expense and administrative burdens associated with paying employment taxes; the proliferation of illegal child care providers and their effect on compliance with employment tax provisions; the tendency to dissociate domestic work from other professions where labor is performed outside of private homes; and the under-enforcement of the nanny tax provisions.

Part IV of the Article addresses the long-term costs to both the employers and employees who fail to follow the law. Part V considers the role of the child care credit and the disallowance of a deduction for in-home child care in discouraging employers to pay employment taxes for their household workers. This Article suggests that household employer compliance will increase if household employers and their employees are informed of the benefits associated with legal employment, threatened with sufficient punitive measures to deter under reporting, and given tax incentives that mitigate the expense of paying the nanny taxes.

I. PAYMENT OF THE NANNY TAX

There are federal and state tax implications associated with hiring a household employee. Domestic employers are required to pay social security and Medicare ("FICA") taxes and federal unemployment ("FUTA") tax.²² Collectively these federal taxes have been referred to by the media as "Nanny Taxes." The nanny tax burden is divided equally between the household employer and employee.²³ In addition to the required employment taxes (FICA

21. See *infra* notes 31-37 and accompanying text for a discussion of the simplification of the employment tax payment procedures.

22. The employer and employee must each pay FICA and FUTA taxes. The social security tax is 6.2% up to a wage ceiling that is adjusted annually for inflation (\$61,200 for 1995 and \$62,700 for 1996, 1997, and 1998). The Medicare tax is 1.45% and has no wage ceiling. The total nanny tax is 15.3% of the employee's cash wages. See I.R.C. §§ 3101(a) & (b), 3111(a) & (b) (1994).

23. See Efreem Z. Fisher, *Child Care: The Forgotten Tax Deduction*, 3 CARDOZO WOMEN'S L.J. 113, 117 (1996). The employer may choose to pay the employee's portion of the social security and Medicare taxes instead of withholding the taxes from the employee's cash compensation. When the employment taxes are paid by the employer, the taxes are not included as wages subject to further employment tax. However, payment of the employee's employment tax

and FUTA), the employer may agree to voluntary federal income tax withholding.²⁴ Domestic employers may also make advanced earned income payments to qualifying employees.²⁵

Four years ago Congress simplified the procedure for reporting wages paid to domestic employees, including nannies, by enacting the Social Security Domestic Employment Reform Act (the "Reform Act") of 1994.²⁶ The Reform Act permits domestic employers to annually pay and report employment taxes on their own Form 1040, Schedule H.²⁷ The Reform Act provides that employment taxes (FICA and FUTA) must be paid by individuals who employ domestic workers, such as nannies, whom they pay \$1000 or more in any taxable year.²⁸ Domestic service provided by certain family members and any individual under the age of eighteen whose principal occupation is not domestic service are exempt from the nanny tax requirements.²⁹

Under prior law, household employers were required to file quarterly statements, end-of-the-year wage and tax statements, and end-of-the-year transmittal of income and tax statements.³⁰ The Reform Act made three

liabilities requires inclusion of the amount in the employee's gross income. The employee may ultimately bear the burden of the entire tax if the employers contribution is taken out in the form of lower salary. *See id.*

24. The IRC exempts household employers from the withholding requirements. Remuneration paid for household services performed by an employee in the home of the employer is not subject to withholding. I.R.C. § 3401. Income tax withholding is not required from wages paid for domestic services performed in private homes and clubs provided it is not used primarily to supply board or lodging as a residence. *See A Guide to the Nanny Tax*, Fed. Tax Coordinator (RIA), ¶¶ 109, 111. Household services include services performed by cooks, maids, governesses, and babysitters. *See* Treas. Reg. § 31.3401(a)(3)-1(a)(1) (1998). An employer, however, may voluntarily agree to withhold federal income taxes for the nanny's wages. *See id.*

25. *See* I.R.S. Notice 89-95, 1989-2 C.B. 417. If the employer withholds income tax, the employer must give the employee notice as to the earned income credit. If the employee provides the employer with an Earned Income Credit Advances Payment Certificate, then the employer must make the advanced earned income credit payment to the employee as requested. The payments are made out of the employment taxes paid by the employer. *See id.*

26. P.L. 103-387, 108 Stat. 4071 (1994).

27. I.R.C. § 3510(a) (1994).

28. The threshold amount was \$1100 in 1998. *See* I.R.C. § 3121(x) (West Supp. 1998).

29. *See* I.R.C. § 3121(b)(21) (1994).

30. IRC § 3510 provided that returns with respect to domestic service be filed on or before the 15th day of the fourth month. I.R.C. § 3510. Thus, employment taxes, social security taxes, and Medicare taxes were paid every quarter. Federal unemployment taxes were paid annually, but individual states may require more frequent payments. A Form W-2 must be given to the employee reporting wages paid during the last year. A copy is then sent to the Social Security Administration. An Employer's Quarterly Tax Return for Household Employees (IRS Form 942) must also be filed every quarter. *See* Dan Moreau, *Got Household Help? Get This Right: If You Pay for Child Care or Housework, Chances are Good You Owe the IRS a Form 942*, KIPLINGER'S PERS. FIN. MAG., Jan. 1994.

fundamental changes to simplify the payment of employment taxes and significantly reduce the administrative requirements associated with the payment of the tax.³¹ First, it eliminated the quarterly reporting requirements.³² Second, it increased the threshold amount from \$50 to \$1000.³³ Third, it exempted wages paid to certain family members and weekend baby sitters.³⁴

The purpose of the law was to establish new enforcement mechanisms and to improve employer compliance to ensure that domestic workers receive the social security and unemployment coverage to which they are entitled.³⁵ Congress was hopeful that the new law would increase the number of employers paying the tax by providing a simplified payment procedure and having taxpayers sign under penalty of perjury that the household employer owed no taxes for the year.³⁶ While taxpayer response to the new rules was immediate, it was not what Congress had anticipated. The simplification of the nanny tax reporting requirements has had an adverse effect on nanny tax compliance.³⁷

The numbers are alarming. In 1994, the number of household employers filing employment tax returns was 500,000.³⁸ In 1995, the first year the new law was in effect the number fell to 300,000.³⁹ In 1996, the numbers remained approximately the same and were not expected to increase in 1997.⁴⁰ In the end, the legislative effort to protect the interests of domestic employees resulted in the number of domestic employers paying the nanny tax plummeting by almost forty percent.⁴¹

II. REASONS FOR NONCOMPLIANCE

Household employers evade the payment of employment taxes for a variety of reasons. The ease with which household employers break the law by not paying employment taxes may not reflect complete disdain for the tax itself, but may be an indictment on the system that commands its payment.

31. See H.R. REP. No. 103-491, at 3266 (1994).

32. This change was implemented with the addition of Line 52 to the individual income tax return asking for the amount of Social Security and Medicare taxes owed for household workers.

33. P.L. 103-387, § 2, 108 Stat. 4071 (1994).

34. *Id.*

35. See H.R. REP. No. 103-491, at 3266.

36. Under the new law, nanny taxes are reported on Line 52 of Income Tax Form 1040. This form is signed under penalty of perjury. Taxpayers who fail to pay nanny taxes are lying to the government.

37. See *IRS Finds More People Are Skipping Nanny Tax Simplified Rules Bring Increase in Cheating*, CHI. TRIB., Apr. 5, 1998, at 15. The *Chicago Tribune* reports that based on estimates as many as four million people owe nanny taxes, but fewer than one in 13 are complying with the law. *Id.*

38. See *id.*

39. See *id.*

40. See *id.*

41. See *id.*

Succumbing to the temptation to cheat on your taxes is almost inevitable when no one else is paying the tax. Extreme noncompliance trivializes the law to the point that breaking it seems prudent rather than immoral. The politicization of the nanny tax issue has not helped, as taxpayers perceive the media debate over the payment of nanny taxes to mean that only those with political aspirations need obey the law.⁴² In fact, many household employers may not recognize the establishment of an employee/employer relationship with their household worker.⁴³ For most of us, the term "nanny tax" is associated with women like Mary Poppins or Alice on the Brady Bunch, instead of Jane Neighbor from the apartment next door who comes over every afternoon to watch the kids.

Many taxpayers view the Internal Revenue Service ("IRS") as the enemy, and are distrustful of any attempt to collect taxes owed, even if properly assessed, making even otherwise honest people more comfortable with evading taxes owed.⁴⁴ Part of the problem is that as with other taxes, the economic burdens associated with paying the nanny tax are relatively large in relationship to the perceived benefits.⁴⁵ It is the child care provider who is the direct recipient of the benefits associated with the payment of the nanny tax.⁴⁶ However, the child care provider is a potential taxpayer, also motivated by tax avoidance. Therefore, many child care providers may be willing to forgo the long-term benefits of reporting their income in order to satisfy short-term financial needs. Because the

42. *See id.* As one working mother puts it, "My accountant told me I have to stop this and issue paycheck stubs and report what I pay to the IRS But since no president is ever going to nominate me for the Cabinet, what do I care about paying this stupid nanny tax? And if I get caught, I'll just pay the fine and go on doing what I am doing." *Id.* This mother's extreme focus on her own self interest and complete disregard for the long-term economic security of her nanny typifies the plantation mentality that pervades domestic employment.

43. The nanny tax is triggered in any year in which the household worker is paid in excess of \$1000. *See* I.R.C. § 3121(a)(7) (West Supp. 1998).

44. *See* Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy and How We Can Make Them Sane*, 16 VA. TAX. REV. 155, 157 n.2 (1997); *see also id.* at 174 n.45.

In support of this position, Professor Rosenberg gives the following example:

When law school tax classes discuss the fact that a taxpayer who finds \$100 is subject to tax on that treasure trove, students . . . ask "why would anyone report it anyway?"

If a student replies "it's the law," her answer is more often than not met with derisive laughter; yet those same students who laugh at the idea of paying \$31 in tax (assuming a 31% marginal tax rate) . . . would not steal \$31 from a classmate even if they were assured they would not be caught

Id.

45. *See id.* at 171-72. The problem with taxes is the association between the payment of taxes and frustration and sacrifice. The separation of tax benefits and government services from burdens create the impression that the taxes are punishments. *See id.*

46. *See id.* at 179. Professor Rosenberg suggests that the reason taxpayers do not realize what they are paying for with their tax dollars is that the person who actually pays the tax enjoys no more benefits than the person with equal assets who evades the tax. *Id.*

employer and the employee both perceive the benefits of establishing a legal employment relationship as minimal in comparison to the immediate economic burdens, incentives must be provided to encourage compliance.

A. Paying the Price

Many household employers fail to pay their nanny taxes because it is too expensive. The cost of employing an in-home child care provider exceeds the cost of other types of child care, such as day care facilities, or group care in private homes.⁴⁷ Most families find that paying the child care is a financial strain. After mortgage and rental expenses, child care represents the largest item on many family's budget.⁴⁸

Paying employment taxes increases the cost of child care substantially. Based on one estimate the average salary of a full time nanny is approximately \$280 per week, or \$14,500 for the year.⁴⁹ Social security and FICA on this amount are \$2218 per year.⁵⁰ Because of the prevalence of illegal employment, many nannies may be unwilling or unable to pay their share of the employment taxes leaving the employer paying the entire amount. In addition the employer must pay FUTA and state taxes for disability and unemployment insurance. In the end, compliance with the employment tax laws amounts to approximately \$2500.⁵¹

B. Red Tape

The complications associated with paying household employment taxes provides an additional reason for noncompliance by household employers. Under current law, federal employment taxes are reported, and paid, annually on the employer's Form 1040.⁵² However, payment of employment taxes at the end of the year requires detailed record keeping throughout the year. The employee must be given a Form W-2 for income tax purposes, a copy of which must be sent to the Social Security Administration. To accurately report income on Form W-2, the household employer must account for all cash wages paid to the employee for the year. To complete Form W-2, the employer is required to follow complex instructions and perform mathematical calculations that many taxpayers find intimidating.

In addition to the federal income tax laws, the employer must also comply with state income and employment tax laws. Unlike the federal employment tax procedures, many states impose quarterly filing requirements on household employers.⁵³ In addition to the federal and state reporting requirements, the

47. See *infra* notes 96-97 and accompanying text.

48. Nantell, *supra* note 16, at 884.

49. See *A NaniNet* (visited Oct. 7, 1998) <<http://www.4nannytaxes.com/tips.htm>>.

50. The social security tax on this amount is 6.29%. The Medicare tax is 1.45%. See *id.*

51. See *id.*

52. See *supra* note 27 and accompanying text.

53. In California, for example, domestic employers must register with the Employment

Immigration and Naturalization Service ("INS") also imposes obligations on household employers. The immigration status of a new employee must be verified.⁵⁴ Once the employer verifies the worker's eligibility to work in the United States, Form I-9 must be completed and maintained in the employer's records.⁵⁵

Passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (the "Reconciliation Act")⁵⁶ increased the burden on employers of household employees. Under the Reconciliation Act, all employers are required to report information on newly hired employees.⁵⁷ The purpose of the act is to track the employment of non-custodial parents for purposes of collecting child support.⁵⁸ All employers must comply with the federal requirements regardless of the size or type of business. The Reconciliation Act requires a household employer to report the nanny's name, address, social security number, date of hire and date of birth. Certain employer information, such as name and address must be provided as well.⁵⁹

C. *Illegal Immigrant Workers*

The proliferation of the immigrant workforce has spawned a ground swell of willing illegal immigrant child care providers. In certain areas of the country, hiring an illegal immigrant child care provider is commonplace. Illegal immigrant nannies are often referred to potential employers by legitimate employment agencies when they do not have enough legal applicants to meet employer demand.⁶⁰ In major metropolitan areas, household employers lament that the only domestic workers who are willing to work long hours for a reasonable price are illegal immigrants.⁶¹

Once an illegal immigrant worker is hired, there is little chance that the

Development Department ("EDD") within 15 days after paying cash wages of \$750 or more in a calendar quarter, and must hold and transmit to the EDD the employee's portion of the tax for state disability. Household employers who pay cash wages of \$1000 or more in a calendar quarter must also pay the employer's portion of the unemployment insurance. *See* RUSSELL S. BICK, 1999 GUIDE TO CALIFORNIA TAXES 627-30 (1999).

54. The Immigration Reform and Control Act of 1986, Pub. L. No. 99-603, 100 Stat. 3359 (1986) (codified at scattered sections of 8 U.S.C.).

55. *See* 8 C.F.R. 274(a) (1994).

56. Pub. L. No. 104-193, 110 Stat. 2105 (1996) (codified at scattered sections of 8 U.S.C. & 42 U.S.C.).

57. 42 U.S.C. § 653a(b) (Supp. II 1996).

58. *See id.* § 653(a).

59. *See id.* § 653a(b). Employers must provide this information to the State Directory of New Hires. *See id.*

60. *See* Deborah Sontag, *Increasing Two-Career Family Means Illegal Immigrant Help*, N.Y. TIMES, Jan. 24, 1993, at 1.

61. *See id.* Zoe Baird claimed that whenever she advertised for domestic service positions, only illegal applicants responded. *See id.*

employer will pay the nanny tax. First, an employer who broke the law by hiring an illegal immigrant is unlikely to comply with employment tax laws. Second, the secrecy of the illegal employer/employee relationship precludes any government interaction for fear of the worker's detection and deportation. Third, completion of the IRS employment tax forms requires the employer to report the employee's social security number.⁶² Without a legitimate social security number, the employer is unable to pay employment taxes.

D. Women's Work

The status given to home labor is inferior to the status given to other types of wage labor in terms of financial status, security and recognition.⁶³ Despite advances of women in the paid labor force, child care and housework are perceived as marital obligations that rest with women. Tasks performed by nanny's such as feeding babies and changing diapers have traditionally been performed for free by women residing in the home.⁶⁴

The delegation of child care to surrogate care takers continued the wage inequality between domestics and other paid laborers.⁶⁵ The earliest household workers were slaves and indentured servants, who cooked, cleaned, and cared for children without financial remuneration. The turn of the century brought immigrant women laborers who received below market wages for their services. Child care has never achieved the status associated with other types of paid labor in terms of earnings, status, and career advancement.⁶⁶

Domestic workers have failed to attain equal status under the law. The reporting requirement for wages paid to household workers is higher than that for

62. Department of the Treas., I.R.S. 1998 Form Schedule H.

63. See Katharine Silbaugh, *Turning Labor into Love: Housework and the Law*, 91 NW. U. L. REV. 1, 14-15 (1996) (discussing the legal treatment of women's unpaid wages).

64. See Kathryn Branch, Note, *Are Women Worth As Much As Men? Employment Inequities, Gender Roles, And Public Policy*, 1 DUKE J. GENDER L. & POL'Y 119, 121 n.7 (1994). Use of the term "working women" to denote women who work in the paid labor force versus in the home illustrates the devaluation of unpaid labor performed at home. The author notes that work is work and that women who work in the home work just as much as women who work outside—the fact that in-home workers are not financially compensated does not change the character of the labor performed. *Id.*

65. *Id.* at 138 n.70 (citing U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 426 & tbl. 671 (113th ed. 1993) [hereinafter 1993 STATISTICAL ABSTRACT]). Professional child care is one of the lowest paying jobs in this country. See 1993 STATISTICAL ABSTRACT, at 426, tbl. 671. Truck drivers earn almost three times as much. See Branch, *supra* note 64, at 138 n.72.

66. Women who spend a substantial amount of time in the unpaid work force worry that their responsibilities as a homemaker will not translate into marketable skills that can be carried over into the paid labor force. This is equally true for women who perform domestic service in the paid labor force by providing household services to another family. See Silbaugh, *supra* note 63, at 73.

other workers, exempting more domestic workers from social security upon retirement.⁶⁷ The National Labor Relations Act ("NLRA")⁶⁸ excludes individuals employed as domestic workers in private homes.⁶⁹ This exclusion denies domestic workers the opportunity to organize under NLRA protections for increased wages or benefits.⁷⁰

Excluded from the Occupational Safety and Health Act ("OSHA")⁷¹ definition of employer is an individual who, in their own residence, privately employs a person to perform domestic tasks, such as caring for children.⁷² While it may be argued that domestic employers employing an individual household worker should not fall within the scope of the OSHA requirements, in other contexts the term employer is interpreted broadly enough to include an employer who only employs one employee. Most state worker's compensation statutes also fail to protect domestic workers.⁷³

It is debatable whether the inferior status given to domestic work is attributable to the value placed on the work performed, or the women workers providing the services. The two, however, cannot be separated as cultural devaluation of child care work relates both to the status given to housework and gender inequities in employment in general. Domestic work remains primarily women's work and women's work is notoriously under-paid.⁷⁴

Reliable in-home child care enables women to fulfill the demands of professional employment. Traditional gender roles envision the workaholic man consumed by his career while his wife stays home to cook, clean and raise children. Liberation from household chores and child care responsibilities allows women to compete with men free from the same domestic obligations.

In dual-income families, the solution to the division of household labor problems is often to hire another woman to perform these domestic functions for very low pay.⁷⁵ Thus, the advancements made by professional women through

67. The earnings threshold for social security coverage for household workers is \$1000 per year. *See* Social Security Domestic Employment Reform Act of 1994, Pub. L. No. 103-387, 108 Stat. 4071 (increasing the quarterly threshold of \$50 to an annual threshold of \$1000 exempting more domestic workers from coverage under the act).

68. 29 U.S.C. §§ 141-97 (1994 & West 1998).

69. *See id.* §§ 141-42(1) (West 1998).

70. *See id.*

71. *Id.* §§ 651-78 (1994 & Supp. II 1996).

72. *Id.* § 652 (1994). OSHA applies to employers who are "engaged in a business affecting commerce." *Id.*

73. *See* 4 ARTHUR LARSON, *THE LAW OF WORKMEN'S COMPENSATION* (1995). Only New Hampshire applies worker's compensation statutes to all domestic workers. Twenty-three states apply worker's compensation statutes within certain limited restrictions. The remaining states do not apply worker's compensation statutes to domestic workers at all. *See id.*

74. *See* Awida R. Marquez, *Comparable Worth and the Maryland Era*, 47 MD. L. REV. 1129, 1150 (1988) (arguing that jobs are undervalued because women hold them).

75. *See* ROSANNA HERTZ, *MORE EQUAL THAN OTHERS: WOMEN AND MEN IN DUAL-CAREER MARRIAGES* 159 (1986).

the assignment of child care duties have been made at the expense of women without comparable professional skills or opportunities. When child care responsibilities are given to an in-home child care provider, the woman of the household typically functions as the house manager, dictating the hours and terms of employment to the household worker.⁷⁶ This means that improving the working conditions associated with child care is dependent on women protecting the rights of other women and recognizing the economic value of child rearing.

E. Crime and Punishment

The final, and most disturbing, reason for noncompliance is that many taxpayers do not fear detection or retribution. They just do not think that they will be caught. The tax system is based on taxpayer self-assessment, which is reinforced by the threat of detection and prosecution.⁷⁷ It has been suggested that absent these threats, taxpayers will cheat on their taxes when the opportunity is present.⁷⁸ It is undeniable that a taxpayer is more likely to pay a tax when it cannot be avoided, such as when the tax is withheld from the taxpaying employee's paycheck.⁷⁹ However, when a taxpayer is responsible for reporting items of income, many receipts are likely not reported at all.⁸⁰

The payment of employment taxes is entirely dependent on taxpayer self-assessment and reporting. The tax is not withheld from the employer's paycheck; therefore, the tax is paid only when the household employer takes affirmative steps to accurately report, assess, and pay the tax. Because the domestic employment relationship occurs in the privacy of the taxpayer's home, the government can never really know if the taxpayer is employing a household worker, absent intrusive home surveillance devices. Even when the household employer properly reports the employment relationship, the IRS must completely rely on taxpayer self-assessment for the proper reporting of wages subject to the tax.⁸¹

76. See Branch, *supra* note 64, at 124. Branch states that men's participation is that he "helps" with "her" housework; she hires and instructs the cleaning woman and the baby-sitter. In other words, we have progressed to the point where a woman is allowed to delegate her responsibilities in the home, but it is still clearly her responsibility to make sure the children are cared for and the house is clean.

Id.

77. See JOHN S. CARROLL, HOW TAXPAYERS THINK ABOUT THEIR TAXES: FRAMES AND VALUES IN WHY PEOPLE PAY TAXES 43 (Joel S. Slemrod ed., 1992).

78. See ERIC RICE, THE CORPORATE TAX GAP: EVIDENCE ON TAX COMPLIANCE BY SMALL CORPORATIONS IN WHY PEOPLE PAY TAXES 125 (Joel Slemrod ed., 1992).

79. See Rosenberg, *supra* note 44 (reporting that compliance is higher only among wage earners whose taxes are withheld at the source).

80. See *id.*

81. When the household employer pays the worker in cash, it is impossible for the IRS to accurately assess the wages paid. Of course, any statements by the employer and/or employee will be completely self-serving and unreliable inasmuch as it is unrealistic to think that the employer

The IRS has failed to diligently enforce the nanny tax provisions. Few cases of employment tax evasion are prosecuted. While the IRS has threatened to step up its enforcement efforts with few results, compliance with the nanny tax provisions continues to decrease.⁸²

The INS has faced similar problems in the enforcement of employment laws. In 1986, Congress passed the Immigration Reform and Control Act ("IRCA").⁸³ IRCA requires employers to verify an employee's eligibility to work in this country and imposes fines and possible imprisonment on employers who knowingly hire undocumented workers.⁸⁴ IRCA applies to all employers, including those employers who employ individuals to work in private homes, such as nannies.⁸⁵

Enforcement of IRCA has been limited to larger employers of low paid service workers, such as restaurants, hotels, landscapers and cleaning services.⁸⁶ Although domestic employers who fail to comply with the law are at risk of receiving minor fines if caught,⁸⁷ the INS has issued statements that the provisions of IRCA will not be imposed against household employers, thereby allowing the practice of hiring illegal workers to continue unabated.⁸⁸

III. PRIVATE FAILURES/PUBLIC BURDENS

Due to factors such as the number of full-time women professionals, an increase in the number of American families earning more than \$100,000 per year, and the number of immigrants entering the United States, the number of women employed as domestic workers should be on the rise.⁸⁹ In fact, quite the

would fail to pay the tax, the employee would fail to report the income, and they would be completely truthful with the IRS.

82. See Patrice Apodaca, *INS Preparing for "Nanny Tax" Crackdown?*, L.A. TIMES, Jan. 31, 1996, at D-6; Ben Wildavsky, *More Calls to IRS About Domestic Employees; Zoe Baird Case Raises Awareness*, S.F. CHRON., Jan. 23, 1993, at C10 (discussing an active investigation of only 50 cases in a major metropolitan area, which is indicative of how many non-compliance cases fall through the cracks).

83. Pub. L. No. 99-603, 100 Stat. 3359 (1986) (codified at scattered sections of 8 U.S.C.).

84. 8 U.S.C. § 1324a (1994 & Supp. III 1997). The regulations provide that a person who engages in a pattern or practice of violation of the Act shall be subject to fines of no more than \$500 for each unauthorized worker, imprisonment for not more than 6 months, or both. 8 C.F.R. § 270.3(b) (1998).

85. *Id.*

86. See Stanley Mailman, *The Employer as Immigration Inspector*, N.Y. L.J., Apr. 22, 1996, at 3.

87. See *id.* In addition to receiving minor fines, high-profile employers may also receive damaging publicity. See *id.*

88. See *id.*

89. See David Frum, *Domestic Workers*, CURRENT, May 1997, at 39. Frum reports that roughly 15 million American women work as professionals and that an equal number of immigrants have entered the country since 1970. Almost six million American households earn more than

opposite is occurring. As recently as 1972, nearly 1.5 million workers, virtually all women, worked as domestic servants.⁹⁰ Over the past twenty-five years these numbers have collapsed. By 1983, less than a million workers were employed as full-time domestics.⁹¹ The Department of Labor projects that this shrinkage is likely to continue with the number of women working as in-home, full-time child care providers (a subdivision of the larger domestic worker category) dropping from its current level of 350,000 to between 75,000 and 200,000 over the next ten years.⁹²

Both legal and illegal workers are employed as child care providers.⁹³ This is a distinction that often dictates the worker's salary, benefits, hours, and working conditions. The competition to find and hire "qualified"⁹⁴ legal domestic help has become fierce.⁹⁵ Salaries have skyrocketed, as have nannies'

\$100,000 per year (twice as many as in 1980) and almost one million families earn more than \$200,000 per year. *See id.*

90. *See id.*

91. *See id.* Only 980,000 women worked as full-time domestics in 1983; only 820,000 in 1995. *See id.*

92. *See id.*

93. *See Delaney, supra* note 15, at 310-11. Falling within the legal classification of legal child care providers, but outside of the "nanny tax" issues are au pairs. The Au Pair Exchange Visitor Program allows young people, who are not domestics by vocation, to work temporarily in the home of American host families. Au pairs receive free room and board as well as a salary of approximately \$100 per week from the host family. Employers using au pairs as child care providers do not have to comply with the "nanny tax" provisions because services provided by au pairs are not subject to FICA or FUTA withholding. *See id.*

See also Kathy Boccella, *Nanny Shortage Reaches Crisis Point Qualified Caretakers Fetch Top Dollar, Get "Posh" Jobs*, TIMES-PICAYUNE, Dec. 26, 1998, at R9. While using an au pair as a nanny presents an alternative to costly legal, or illegal, employment, the publicity received following the death of an eight-month-old baby while under the supervision of a British au pair, Louise Woodward, has had a chilling effect on the hiring of au pairs. As a result of the case, the number of au pairs plummeted, decreasing from a high of 11,000 in the mid 1990s to just 3000 in 1997. *See id.*

94. I cannot say with certainty what "qualified" means. My opinion, which is purely anecdotal, based on research for this Article and from what I have observed as a parent of a toddler in a major metropolitan area, is that "qualified" means English proficient—a buzz word for English as a first language—having a driver's license, and some college education. Based on the qualifications given, "qualified" nannies tend to be Anglo- or European-American. It is certainly true that there is a distinction between working as a "nanny" and a "housekeeper" who also watches the children. I employ a worker from Central America as a "nanny" meaning her primary obligation is to care for my child. However, she has been referred to by others as my "Girl" my "Maid" and my "Housekeeper," but never as my "Nanny." I can only speculate that if she was born in Europe the nomenclature would be different.

95. *See Boccella, supra* note 93, at R9. One prospective household employer unsuccessfully attempted to lure a nanny by offering a salary of \$500 per week, paid vacations and holidays, overtime, use of a car, and tuition reimbursement. *See id.*

demands. In major cities a full-time nanny receives a salary of about \$400 per week.⁹⁶ For college-educated nannies that amount can exceed \$1000 per week.⁹⁷ Once found, a competent, reliable, educated nanny is a coveted member of the household to be retained at all costs. Nannies demand and receive perks such as cars, mobile telephones, health care benefits, and paid vacations.⁹⁸ In this seller's market, qualified nannies control the parameters of the employment relationship.

The picture is quite different for illegal immigrant child care workers and those American workers who are considered less "qualified." In-home child care providers are unprotected by labor laws.⁹⁹ Domestic workers are denied the opportunity to organize, leaving employers with the power to dictate the rates of pay, working hours, and other terms of employment.¹⁰⁰ The relationship between household employers and employees transpires behind closed doors, facilitating exploitation. This is particularly true with respect to live-in nannies. Live-in nannies may be required to work longer hours. Further, the conditions of their employment may be ill-defined because the employee is in the home and continuously available to the employer.

For illegal immigrant nannies, the balance of power weighs even more heavily in favor of the employer.¹⁰¹ Immigration status restricts job mobility making illegal immigrant child care providers more dependent on employers. Illegal immigrant nannies may feel powerless to question the terms of their employment for fear of employer retribution. Illegal immigrant workers are unable to utilize governmental agencies to enforce their legal rights. Fear of INS detection isolates illegal immigrant workers from other household employees.¹⁰²

The high cost of hiring a college educated, English-speaking child care provider has left many families looking for a less skilled replacement. The economics of domestic work and the creation of an underground domestic service market has attracted a legal as well as illegal immigrant work force.¹⁰³ This has changed the complexion of domestic help. Twenty years ago domestic service was a black woman's job with nearly forty percent of domestic workers being African American.¹⁰⁴ In 1995, fewer than seventeen percent of domestic workers were African American.¹⁰⁵ The thriving illegal child care market depresses

96. *See id.*

97. *See id.*

98. *See id.* A survey conducted by the *Nanny News* found that nearly all nannies got paid vacations and holidays, over half got paid sick days, many received health insurance, and several received other perks such as cash bonuses and club memberships. *See id.*

99. *See supra* note 68 and accompanying text.

100. Silbaugh, *supra* note 63, at 72.

101. *See generally* Peter Margulies, *Stranger and Afraid: Undocumented Workers and Federal Employment Law*, 38 DEPAUL L. REV. 553, 533-34 (1989).

102. *Id.*

103. *See infra* note 123 on the number of immigrants working as child care providers.

104. *See* Frum, *supra* note 89.

105. *See id.* This trend can be attributed to a number of factors: African American women no longer want to do the work, employer prejudice in hiring household workers and "white guilt"

wages and benefits for all but a few domestic workers. These economic and cultural trends have stigmatized domestic work, encouraging unskilled American workers to take other jobs even if they pay less.¹⁰⁶

Many nannies acquiesce in their employer's evasion of the tax laws. Illegal immigrant workers, fearful of INS detection, cannot establish a legal employment relationship for purposes of paying the tax; therefore they only receive wages under the table. Low-paid legal workers prefer to work illegally to increase the net amount of their take home pay. Other household workers feel powerless in the employment situation. Unable to enforce their legal rights, they accept the terms of employment as offered by the employer. Because it is common practice for domestic employers not to pay or to withhold employment taxes, an employee seeking legal employment is restricted to fewer positions.

Working underground is not without its long term costs to domestic employees. Social security payments are made based on FICA contributions from the employer and deductions from the employee's paycheck.¹⁰⁷ If the employer fails to pay employment taxes, the employee may not be entitled to receive social security payments upon retirement. Without payment of the FUTA premiums, the employee will not be entitled to federal unemployment payments either.¹⁰⁸ Additionally, failure to comply with the state employment tax requirements disqualifies the child care provider from receiving state unemployment and disability compensation.¹⁰⁹

Illegal employees are also excluded from other entitlements associated with the wage labor market. Illegal employees have no verifiable wages, making it virtually impossible to qualify for a mortgage, rent an apartment, or finance an automobile. Illegal workers have no work history to transition into other types of employment. A domestic worker may receive a letter of recommendation to secure other domestic work, but not work in a legal wage market. The inability to establish credit, access traditional financial services, and transition into other wage labor markets restricts upward economic mobility, thereby reinforcing the "servant" underclass.

The short-term benefit of avoiding employment and income taxes may not be worth the long-term price.¹¹⁰ The income tax system is being used to deliver

over perpetuating black servitude. *See id.*

106. This applies to uneducated and unskilled workers. College educated nannies are heavily in demand, receiving high salary and benefits. *See supra* notes 96-98 and accompanying text.

107. *See* I.R.C. §§ 3101, 3201, 3221 (1994 & Supp. II 1996 & West Supp. 1998).

108. The Federal Unemployment Tax Act ("FUTA") originally exempted domestic workers. Congress amended FUTA to cover domestic employees earning more than \$1000 per quarter. *See* Deborah Maranville, *Changing Economy, Changing Lives: Unemployment Insurance and the Contingent Workforce*, 4 B.U. PUB. INT. L.J. 291, 301 (1994).

109. *See id.*

110. Assuming an average salary of \$14,000 for a single full-time child care provider the employment tax liability would be \$1071 and the federal income tax liability as high as \$1057.50, assuming a standard deduction of \$4250, personal exemption of \$2700 and a 15% tax rate.

substantial work-related federal income transfers to employees.¹¹¹ Federal tax subsidies, such as the earned income credit, increase employee cash wages in excess of federal tax liability.¹¹² The earned income credit is a federal tax subsidy, which can only be received by workers who report items of income by filing an income tax return.¹¹³

The earned income credit is a refundable income tax credit provided to qualified workers at a low to moderate income level.¹¹⁴ The credit was established to encourage work by supplementing employee wages and offsetting the increasing cost of living and social security taxes. To receive the credit the employee must file an income tax return. If the employee is eligible, the employer may make the advanced earned income credit payment directly to the employee each pay period.¹¹⁵

An employee is eligible to receive the credit if the employee earned less than \$25,760 and has at least one qualifying child living in the same household or if the employee earned less than \$29,290 and had more than one qualifying child living in the same household.¹¹⁶ Employees without a qualifying child may still receive the credit if they earned less than \$9770.¹¹⁷ For nannies whose salaries hover around minimum wage, receipt of the earned income credit increases the employee's net "take home" pay. However, many domestic workers unfamiliar with the income tax system may not be aware of this federal tax subsidy.

Noncompliance with the nanny tax requirements has cost employers as well, because federal child care subsidies are delivered through the tax code. Federal child care subsidies include the dependent child care credit, as well as employer dependent care assistance programs.¹¹⁸ To receive these subsidies, the taxpayer

111. See Mary L. Heen, *Welfare Reform, Child Care Costs, and Taxes: Delivering Increased Work-Related Child Care Benefits to Low-Income Families*, 13 YALE L. & POL'Y REV. 173, 175 (1995) (noting that one example of the integration of the tax and income transfers systems is the expansion of the refundable earned income tax credit).

112. See *infra* notes 113-17 and accompanying text for a discussion of the benefits paid under the earned income credit.

113. The earned income credit reduces the amount of taxes the employee owes and may provide a refund in excess of tax liability. The credit is received by completing IRS Form W-5 and Line 59 on Form 1040.

114. IRC § 32 allows a refundable credit against the income tax. I.R.C. § 32 (1994 & Supp. II 1996).

115. An employee is eligible to receive advanced earned income credit payments if the following three conditions are met: (1) the employee has at least one qualifying child; (2) the employee expects that her 1999 earned income and modified adjusted gross income will each be less than \$26,928, including spousal income if the employee plans to file a joint return; and (3) the employee expects to be able to claim the earned income credit in the applicable year. See Department of the Treas., I.R.S. 1998 Form W-5.

116. See I.R.C. § 32.

117. See *id.*

118. See *infra* notes 132-37 and accompanying text for a discussion of dependent care assistance programs.

must provide child care provider information, such as the name, social security number, and address of the child care provider.¹¹⁹ Receipt of the currently available federal tax subsidies, while not enough to encourage employer compliance, can alleviate part of the burden associated with paying the tax.

The federal revenue lost by domestic workers' unreported income results from billions of dollars in unreported payments for child care.¹²⁰ Depletion of the federal income tax base is not the only cost of unreported domestic service income; the ultimate burden for providing for individuals unable to provide for themselves and their families is borne by society at large. Without social security, disability, and unemployment compensation, domestic workers are more susceptible to dependence on other government programs such as welfare if they become sick or lose their jobs.¹²¹

IV. MODELS FOR REFORM

It is impossible, absent extreme punitive measures such as intruding on the privacy of the employer's home, and coordination between federal agencies such as the INS and the IRS, for the government to deter the hiring of illegal domestic workers. Reform must come through encouraging taxpayers to voluntarily comply with the employment tax laws.

Compliance can be increased by attacking three fronts: enforcement, information, and incentives. It is only when household employers receive incentives, fear retribution, and are informed of how to comply with the law that any increase in the voluntary payment of employment taxes will occur.

A. Enforcement

Enforcement of the nanny tax provisions provides the best weapon to combat evasion of the employment taxes by household employers. To enforce the law, taxpayers subject to the tax must be identified and stiff penalties must be imposed. Despite the flagrant flouting of the law by household employers and the publicity surrounding the issue in recent years, there has been very little enforcement of the nanny tax provisions. The IRS has suggested more diligent enforcement of the nanny tax provisions for some time with few results.

Enforcement of the nanny tax provisions is easier than enforcing other IRC

119. Taxpayers who want to take the dependent Child Care Credit or receive employer provided child care benefits must complete Form 2441. The form requires the taxpayer to furnish the providers name, address, social security number and the amount paid. Department of the Treas., I.R.S. Form 2441.

120. See Larry Tumell et al., *Nannygate: An Overview Of Payroll Tax Rules and Immigration Laws*, J. ACCT., July 1993, at 36.

121. These workers are often immigrants. In California, the percentage of immigrant child care workers has jumped from 20% in 1980 to 56% in 1996. See Patrick J. McDonnell, *Jobs Exist for Immigrants, Study Finds Labor: Report Says Unskilled New Arrivals Are "Structurally Embedded" in the Economy, Including Growing High Tech Sector*, L.A. TIMES, May 4, 1998, at B1.

provisions because many taxpayers with dependent children are a self-identifying group. Taxpayers with dependent children are entitled to a dependency exemption.¹²² For taxpayers taking the exemption, the age, name, and social security number of the dependent child must be provided on a taxpayer's return.

The review of dependency information provides a valuable tool in enforcing the nanny tax provisions. The IRS can identify returns that list young children, particularly children who are not yet of school age. These returns can be further examined to determine if both parents work outside the home. Other factors can be reviewed based on information contained in the returns, such as gross income and the deduction of expenses paid to child care providers. Collecting this information allows the IRS to trigger certain returns for further review.

Dependency information review will not capture all nanny tax evaders. Taxpayers whose adjusted gross income exceeds certain threshold amounts will be unable to take the deduction.¹²³ These high-income taxpayers do not provide dependency information on their returns. Unfortunately, it is taxpayers whose income exceeds the dependency exemption thresholds that are more likely to use in-home child care. Requiring all taxpayers with dependents under a certain age to list the names, ages, and social security numbers of any dependents would allow the IRS to fairly evaluate the returns of all taxpayers who may be employing a nanny.

Changing reporting requirements for payment of the nanny tax can also aid in enforcement. Currently, certain wages are exempt for purposes of paying the tax. Exempt wages include wages paid to teenage baby-sitters, other household workers under the age of eighteen, wages under \$1200 paid for the calendar year, and wages paid to certain family members. Wages paid to au pairs are also not subject to the nanny tax requirements.¹²⁴ Employers hiring family members and au pairs should be required to file an informational return listing the name, address of the child care provider, and the wages paid for the year. This can help the service in weeding out taxpayers that are not required to pay the tax.

Nanny taxes are currently reported on Line 55 of the 1040 individual tax form.¹²⁵ Line 55 requires the amount owed for social security and Medicare taxes for household employees. A taxpayer who fails to accurately assess and report taxes owed on their Form 1040 is declaring under penalty of perjury that she did not employ a household employee during the tax year. Taxpayers who fail to pay income taxes owed are subject to interest and penalties on the amount

122. IRC § 151 allows a personal deduction (exemption) in calculating taxable income, with an additional exemption for each dependent. I.R.C. § 151 (West Supp. 1998). IRC § 152 defines a "dependent" to include a child of the taxpayer's over half of whose support was received from the taxpayer. I.R.C. § 152.

123. IRC § 151(d)(13) provides that any adjusted gross income that exceeds the threshold amount shall be reduced by two percentage points for each \$2500 by which the taxpayer's adjusted gross income exceeds the threshold amount for 1998. I.R.C. § 151(d)(13).

124. I.R.C. § 3121(b)(21) (as amended by § 2(a)(1)(C) of the Social Security Domestic Employment Reform Act, Pub. L. No. 103-387, 103d Cong, 2d Sess. (1994)).

125. Department of the Treas., I.R.S. 1998 Form 1040, Line 55.

of the deficiency.¹²⁶ These penalties apply to taxpayers who fail to pay employment taxes, which are required to be reported on the employer's tax return.¹²⁷ A penalty is imposed on a taxpayer who without reasonable cause fails to pay tax.¹²⁸ An accuracy-related penalty is imposed if the understatement is due to negligence.¹²⁹ Fraudulent underpayment of a tax required to be reported on the return may result in the imposition of a seventy-five percent penalty.¹³⁰

B. Information

Information must be given to household employers, as well as their tax preparers. Many taxpayers who are overwhelmed by paying taxes on wages and other items of income refuse to pay an additional tax. Household employers who prepare their own tax returns may be unable to grasp the complications of paying employment taxes. While there are services that will do this for household employers, these services are expensive.

Household employers must be given information on ways to reduce the federal tax burden that comes along with hiring legal child care providers and complying with employment tax provisions. The child care tax credit provides a federal tax rebate that is available to defray at least part of the nanny tax expense. To receive the credit, the taxpayer must verify the amount of the expense and identify the child care provider.¹³¹ A second federal tax subsidy, which provides tax-free income to pay child care expenses, is the dependent care assistance program.¹³² This program authorizes employers to provide employees with tax-free dependent care assistance.¹³³

126. See I.R.C. § 6601(g).

127. Following the nanny tax scandal, Zoe Baird paid \$10,900 in taxes, interest penalties, and fines. See Robert L. Turner, *Cough Up, Counselor*, BOSTON GLOBE, Feb. 11, 1993, at 23.

128. IRC § 6651(a)(2) provides that a penalty is imposed when a taxpayer, without reasonable cause, fails to pay the tax. The penalty is 0.5% of the tax assessed each month until the tax is paid. The maximum amount of the penalty is 25%. I.R.C. § 6651(a)(2).

129. IRC § 6662(b) provides that the accuracy-related penalty is imposed if any part of the underpayment is due to negligence or disregard for the rules without the intent to defraud. I.R.C. § 6662(b).

130. See I.R.C. § 6663(a).

131. See *supra* note 119 and accompanying text.

132. IRC § 129(a)(1) provides that the gross income of an employee does not include amounts paid or incurred by employers for dependent care assistance provided to employees. I.R.C. § 129(a)(1). See also Economic Recovery Tax Act, Pub. L. No. 97-34, § 124(e), 95 Stat. 198-201 (1981) (codified at 26 U.S.C. § 129 (1994 & Supp. II 1996)).

133. IRC section 129(d)(1) describes a dependent care assistance program as a separate written plan of the employer for the exclusive benefit of his employees to provide them with dependent care, which meets the following requirements: (1) Discrimination—The contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees; (2) Eligibility—The program benefits a classification of employees set up by the employer that is found by the Secretary of the Treasury to be non-discriminatory; (3) Principal shareholders or

Many dependent care assistance programs are implemented through a salary reduction plan, which costs the employer nothing, but allows the employee to deduct the amount of dependent child care expenses from her gross income and seek reimbursement from the plan for the child care expenses when they are incurred.¹³⁴ When seeking reimbursement for child care expenses, the employee must provide the employer with the child care provider's name, address, and social security number.¹³⁵ Technically, these reporting requirements should restrict receipt of child care credit and dependant care assistance benefits to taxpayers who employ legal nannies.

Employees participating in an employer-provided dependent care salary reduction program may exclude from income taxation up to \$5000 of their wages to pay for child care expenses.¹³⁶ The \$5000 is a deduction from income, allowing wealthier taxpayers to receive a larger tax subsidy. Taxpayers participating in a dependent care assistance program whose income is taxed in the highest marginal tax rate will receive a child care subsidy of approximately \$2000,¹³⁷ an amount that would cover all, or at least a significant portion of, the nanny tax.

Household employees must also be informed of their employment rights.

owners—Not more than 25% of the amounts paid or incurred by the employer during the year are provided for shareholder or owners each of whom owns more than five percent of the stock or the capital or profit interests of the employer; (4) Notification of eligible employees—The employer provides reasonable notification of the availability and terms of the program to eligible employees; (5) Statement of expenses—The plan furnishes to an employee a written statement of amounts paid or incurred by the employer in providing dependent care assistance to the employee; (6) Benefits—The average benefits to employees who are not highly compensated under all employer plans are at least 55% of the average benefits provided to highly compensated employees under all employer plans. Additionally, in the case of benefits provided under a salary reduction agreement, the plan may disregard employees whose compensation is less than \$25,000; (7) Excluded employees—The following employees may be excluded from the eligibility and benefits considerations: (A) Employees who have not attained the age of 21 or completed one year of service (as defined in IRC § 410(a)(3)), and (B) Employees who are not covered in the program who are covered by a collective bargaining agreement between employee representatives and one or more employees, if it is found that dependent care benefits were the subject of good faith bargaining; (8) The program is not required to be funded. I.R.C. § 129(d)(1).

134. See BLANK AND WILLIAMS, *CHILD CARE: WHOSE PRIORITY? A STATE CHILD CARE FACT BOOK* 16 (1985).

135. IRC § 21(e)(9) requires the tax payer to provide this information with respect to a service provider to receive dependent care credit. I.R.C. § 21(e)(9) (1994).

136. IRC § 129(a)(2) provides that the amount, which may be excluded for dependent care assistance, shall not exceed \$5000 (\$2500 in the case of a separate return filed by a married individual). I.R.C. § 129(a)(2) (West Supp. 1998).

137. The highest marginal tax rate imposed by IRC § 1 is 39.6% and is imposed on taxable income over \$250,000 for married individuals filing joint returns, heads of households, and unmarried individuals, and on taxable income over \$125,000 for married individuals filing separate returns. I.R.C. § 1.

Domestic employees may be unaware that their employers are required to pay employment taxes on their behalf. Household employees must be provided with information on the benefits associated with legal employment, such as eligibility for social security and unemployment benefits. Household employees must also be informed of their eligibility to receive the earned income credit. Absent this information, workers are less likely to demand the establishment of a legal employment relationship.

IV. PROPOSALS FOR CHANGE

Although limited child care credits have been permitted under the IRC, a full deduction for child care expenses has been rejected.¹³⁸ Child care has been considered indistinguishable from other nondeductible personal expenses such as food, clothing, and shelter. When an individual taxpayer is allowed to deduct personal expenses, the integrity of the income tax system is threatened, because the government is paying for part of the taxpayer's consumption while others, who are unable to take the deduction, pay the entire cost.¹³⁹ However, tax incentives are provided to encourage taxpayer consumption in particular areas. The classic example is the deduction of home mortgage interest.¹⁴⁰ Homeowners receive a federal tax rebate of a portion of their personal living expenses,¹⁴¹ while renters do not. The efficient implementation of social policy has traditionally justified the vertical inequities created by tax expenditures. Inadequacies in encouraging nanny tax compliance support a deduction for salary paid to in-home child care providers in the current child and dependent care credit.

Household employer compliance with the federal employment tax laws may chill the hiring of illegal immigrant child care providers. This is not the intended

138. See *infra* Parts IV.B.1-2 for a discussion of the deductibility of child care expenses.

139. See Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuses and Restore Some Progressivity into the Tax Code*, 41 CATH. U. L. REV. 581 (1992).

140. From its adoption in 1913, the federal income tax has always contained a deduction for personal residence interest paid by a taxpayer. The deduction of home mortgage interest is one of the oldest tax expenditures in the IRC. The legislative purposes in granting the expenditure is unclear. See TAX BREAKS: AN INTRODUCTION TO TAX EXPENDITURES (W. Barnes ed., 1985).

141. IRC § 163(h) permits the deduction of qualified home residence interest. Qualified home residence interest means interest on a mortgage to acquire or substantially improve the taxpayer's principal residence and one other residence. The maximum mortgage amount on which interest is deductible is one million dollars. Section 163 also permits the deduction of home equity interest when there is adequate equity in the property and the promissory note is secured by the taxpayer's property. The maximum loan amount on which interest may be deductible as home equity interest is \$100,000. However, unlike acquisition indebtedness, the proceeds of a home equity loan do not have to be used to improve the property and can be used for any taxpayer purpose. If taxpayer A purchases a Mercedes 500SL for \$100,000, which is financed with the proceeds of a home equity loan, the interest will be deductible while taxpayer B who uses dealer financing will be unable to deduct the interest on the loan. I.R.C. § 163.

result. The proposals are suggested to improve the working conditions for all domestic employees, legal and illegal. If a critical need for child care providers exists, other policies must be implemented to enable families to employ undocumented workers.¹⁴²

A. *The Child Care Credit*

Historically, child care costs have been treated as inherently personal, nondeductible expenses. This is the result even in the case of two-earner families, where child care is necessary for the production of income.¹⁴³ In 1954 a limited deduction¹⁴⁴ for child and dependent care expenses was added to the IRC.¹⁴⁵ The child care deduction could be taken when the woman caretaker of the family was either working or seeking employment.¹⁴⁶ In 1964, the deduction was expanded to include husbands whose wives were incapacitated or institutionalized.¹⁴⁷ In 1976, the child care deduction was replaced by a child care credit.¹⁴⁸ The amount of the child care credit has varied since 1976;¹⁴⁹ however, a child care credit, rather than a deduction, has been retained since that time.¹⁵⁰

IRC § 21 provides the current credit for employment related household and

142. See generally Delaney, *supra* note 15. One policy is relaxation of the immigration laws to permit parents to hire nonresident child care providers. See *id.* at 317-26.

143. See *Smith v. Commissioner of Internal Revenue*, 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940).

144. The maximum amount deductible under IRC § 214 was \$600, regardless of the number of eligible children. If the child care provider also performed other household duties, the child care expenses had to be prorated. See S. REP. NO. 83-1622, at 220 (1954).

145. Section 214 allowed an itemized deduction for the costs of caring for a child under the age of twelve. I.R.C. § 214 (1954). The deduction also applied to physically or mentally incapacitated dependents. See S. REP. NO. 83-1622, at 36 (1954); H.R. REP. NO. 83-1337, at 30 (1954). The expenses were limited to employment related child care expenses. Expenses were considered to be employment related only if they were incurred to enable the taxpayer to be employed. Therefore, the taxpayer had to be gainfully employed or actively searching employment. See *Treas. Reg. § 1.214A-1(c)(1)(i)* (1954).

146. See Stanfield, *supra* note 4, at 220.

147. See *The Revenue Act of 1964*, Pub. L. No. 88-272, § 212(a), 78 Stat. 19, 49 (1964).

148. See *Tax Reform Act of 1976*, I.R.C. § 44(a), Pub. L. No. 94-455, § 504, 90 Stat. 1520, 1563-66 (1976).

149. The *Economic Recovery Tax Act of 1976* increased the amount of the credit. Pub. L. No. 97-34, § 124, 95 Stat. 172, 197-201 (1981). The *Tax Reform Act of 1984* renumbered the credit to IRC § 21. Pub. L. No. 98-369, §§ 471, 474, 98 Stat. 494, 825-26, 830-47 (1984).

150. As a credit, there is a dollar for dollar reduction in the tax owed. Therefore, the amount of the creditable child care expense is not affected by the taxpayer's tax bracket. Also, the amount is refunded without regard to whether the taxpayer itemizes or takes the standard deduction. See I.R.C. § 21 (West Supp. 1998).

dependent care expenses.¹⁵¹ The credit is allowed for dependent child care expenses, which are necessary for employment for taxpayers who maintain a household, which includes a dependent under the age of thirteen, or a dependent or spouse of the taxpayer who is physically or mentally incapable of caring for himself.¹⁵² The creditable amount is a percentage of the employment related dependent care expenses paid by the taxpayer during the taxable year.¹⁵³ The percentage is thirty percent, reduced by one percentage point for each \$2000 that the taxpayer's adjusted gross income exceeds \$10,000.¹⁵⁴ However, the percentage cannot be reduced below twenty.¹⁵⁵ The maximum amount of employment related expenses that may be considered for the credit cannot exceed \$2400 for one qualifying individual and \$4800 for two or more qualifying individuals.¹⁵⁶

The child care credit is one way the federal government attempts to assist working families defray the costs of child care. The child care credit is the largest federal child care subsidy.¹⁵⁷ Middle class taxpayers—individuals whose

151. IRC § 21 allows the deduction of employment related dependent care expenses. Employment related expenses means amounts paid for expenses for household services and the care of a qualifying individual, but only if such expenses are incurred to enable the taxpayer to be gainfully employed for any period for which there are one or more qualifying individuals with respect to such taxpayer. I.R.C. § 21(b)(2).

152. Only employment related expenses for the care of qualifying individuals are creditable. IRC § 21(b)(1) defines a "qualifying individual" as:

- (A) a dependent of the taxpayer who is under the age of 13 and with respect to whom the taxpayer is entitled to a deduction under section 151(c),
- (B) a dependent of the taxpayer who is physically or mentally incapable of caring for himself, or
- (C) the spouse of the taxpayer, if he is physically or mentally incapable of caring for himself.

I.R.C. § 21(b)(1). IRC section 21(b)(2) defines "employment-related expenses" as: amounts paid for the following expenses, but only if such expenses are incurred to enable the taxpayer to be gainfully employed for any period for which there are 1 or more qualifying individuals with respect to the taxpayer:

- (i) expenses for household services, and
- (ii) expenses for the care of a qualifying individual.

Such term shall not include any amount paid for services outside the taxpayer's household at a camp where the qualifying individual stays overnight.

Id. § 21(b)(2).

153. IRC § 21(a)(1) provides that "in the case of an individual who maintains a household which includes as a member one or more qualifying individuals . . . there shall be allowed as a credit . . . an amount equal to the applicable percentage of the employment-related expenses . . . paid by such individual during the taxable year." I.R.C. § 21(a)(1).

154. See I.R.C. § 21(a)(2).

155. See *id.*

156. IRC § 21(c) provides dollar limitations on the creditable amount. I.R.C. § 21(c).

157. Nantell, *supra* note 16, at 909. In 1993, a \$2.5 billion IRC § 21 child care and

taxable income is between \$20,000 to \$50,000 per year—who have two qualifying dependents are the primary beneficiaries of this federal tax subsidy.

The child care credit is a non-refundable tax credit, meaning that the taxpayer may not take the credit if the creditable amount exceeds the taxpayer's income tax liability. The result is that the poor, taxpayers whose income is below the amount required to file a return, receive no federal tax child care subsidy at all because the amount of the credit exceeds their income tax liability. The inadequacies of the dependent and child care credit in assisting very poor families in paying for child care is a criticism expressed by commentators who believe the credit should be used to deliver child care services to the poor.¹⁵⁸

In the context of domestic service and payment of employment taxes, the current child care credit is an inadequate incentive to encourage household employees to comply with the nanny tax requirements. First, and foremost, the carrot is just not sweet enough. The adjusted gross income of an employer employing a full-time legal nanny is likely to exceed \$30,000. For taxpayers with adjusted gross income that exceeds that amount, the credit is restricted to \$480 (twenty percent of \$2400) if they have one qualifying dependent or \$960 (twenty percent of \$4800) if they have two qualifying dependents.¹⁵⁹ The maximum credit amount is a fraction of what it costs a household employer to comply with the nanny tax provisions.¹⁶⁰

The current child care credit, if increased, could stimulate nanny tax compliance by providing a greater incentive to use legal child care. The creditable amount has not been adjusted for inflation since 1982, causing a forty-five percent decrease in the credit's actual value.¹⁶¹ Adjustments to the credit for

dependent tax credit was given to over 600 million families.

158. See Nantell, *supra* note 16, at 937, 939-41 (noting the short-coming of a non-refundable child care credit); see also Jonathan Barry Forman, *Beyond President Bush's Child Care Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-Income Families with Children*, 38 EMORY L.J. 661 (1989) [hereinafter *Beyond President Bush's Child Care Tax Credit Proposal*]; Jonathan Barry Forman, *Using Refundable Tax Credits to Help Low-Income Families*, 35 LOY. L. REV. 117 (1989).

159. The amount of the credit has not even been increased to pace with rising employment costs. The applicable child care credit amount is calculated by multiplying the creditable employment related expenses by the applicable percentage. The percentage is phased down one point for each \$2000 by which the taxpayer's adjusted gross income exceeds \$10,000. See *supra* note 154 and accompanying text. Neither the applicable credit amounts nor the phase-down schedule are indexed for inflation and have not been increased since 1982. See *Beyond President Bush's Child Care Tax Credit Proposal*, *supra* note 158, at 661.

160. See Nantell, *supra* note 16, at 942. Professor Nantell provides the following illustration: A taxpayer paying \$1000 per month for in-home child care would owe an additional \$918 in nanny taxes for those wages. If the taxpayer only had one qualifying child, and adjusted gross income in excess of \$30,000, the maximum allowable child care credit would amount to only \$480. See *id.*

161. See *id.* at 938 (citing A.B.A. Sec. on Tax'n, *Report of the Child Care Credit Task Force*, 46 TAX NOTES 331 (Jan. 15, 1990)).

inflation would ensure that it keeps pace with the increased cost of all types of child care, including the salary of in-home child care providers. Apart from increasing the creditable amount, loopholes must be closed to prevent taxpayers who employ illegal workers from taking the credit.¹⁶²

One suggested solution, increasing the dependent and child care credit available for household employers, is inefficient in promoting the payment of employment taxes for a number of reasons. First, as a dollar for dollar reduction of the employers tax liability, the difficulties of adjusting the credit to correspond with the salary paid to a domestic worker prevents the use of a credit to offset this expense. Second, a credit for employment taxes paid on behalf of a household employee permits a tax rebate for taxes owed. Third, any attempt to increase the child care credit to employers of private nannies will be rejected as another attempt to provide tax relief to the rich.

B. Rethinking the Salary Deduction for In-Home Child Care Workers

This section addresses two issues: First, the deduction of child care expenses as an ordinary and necessary business expense for working parents, and second, the disallowance of a salary deduction for wages paid to child care employees.

1. *Child Care as an Ordinary and Necessary Business Expense?*—The IRC grants priority to the deduction of business expenses,¹⁶³ permits the deduction of expenses related to income-producing activities within restrictive limitations,¹⁶⁴ and disallows many personal deductions¹⁶⁵ that are unrelated to a trade or

162. See David Cay Johnston, *Despite an Easing of the Rules, Millions Evade "Nanny Tax,"* N.Y. TIMES, Apr. 5, 1998, at 1 (noting that tax payers have figured out ways to get a double benefit by evading the nanny tax requirements while still taking the child care credit).

163. Employer business expense deductions are subtracted from gross income in determining adjusted gross income, and as such are taken above the line. Deductions taken above the line are not subject to the two percent floor requirements of IRC § 67. I.R.C. § 67 (West Supp. 1998). Above the line deductions are also not subject to reduction under the overall limitation of itemized deduction rules in § 68. I.R.C. § 68. IRC § 62(a)(1) provides that deductions, which are attributable to a trade or business carried on by the taxpayer, are deductible from gross income if the trade or business does not consist of the taxpayer's performance of services as an employee. I.R.C. § 62(a)(1). Unreimbursed employee expenses are given a lower priority and are deductible as miscellaneous itemized deductions to the extent that they exceed two percent of adjusted gross income. I.R.C. § 67.

164. IRC § 212 allows a deduction for expenses associated with the production of income, the management, conservation, or maintenance of property held for the production of income, as well as expenses paid in the determination of any tax. I.R.C. § 212. IRC § 62(a)(4) provides that § 212 expenses related to the rental of real property may be deducted above the line. All other § 212 expenses are deductible below the line as miscellaneous itemized deductions. Therefore, deductions for income-producing expenses unrelated to rental activity are deductible only to the extent that they exceed two percent of the taxpayer's adjusted gross income. I.R.C. § 67(a). Section 212 deductions are itemized deductions that are reduced under IRC § 68.

165. Expenses are purely personal when they are unrelated to carrying on a trade or business

business or the production of income. The line between business and personal does not always shine bright. Some expenses directly related to the generation of income are allowed despite the fact that they cross the personal line. For example, commuting expenses between a taxpayer's home and office are nondeductible personal expenses, while commuting costs for travel between two jobs are deductible because they are required by the exigencies of business.¹⁶⁶ A deduction is allowed when a client is taken to lunch, but not when one is dining with a colleague.¹⁶⁷

Child care has never been considered a deductible cost of doing business. In 1940, the federal courts first considered the deductibility of child care expenses in *Smith v. Commissioner of Internal Revenue*.¹⁶⁸ In the *Smith* case, the taxpayers attempted to deduct the expenses of hiring a child care provider after Mrs. Smith, who had previously worked inside the home, re-entered the paid labor force.¹⁶⁹ The taxpayers argued that the child care expenses were ordinary and necessary business expenses.¹⁷⁰ The Board of Tax Appeals held that the child care expenses were not ordinary and necessary business expenses and denied the deduction.¹⁷¹ The *Smith* case exemplifies the sharp divide between tax deductions for personal, business, and income-producing activities. Following the *Smith* case, a limited federal tax deduction was allowed, prior to 1974, for dependent care, which enabled the taxpayer to work. However, in 1975, the deduction was replaced by the current tax credit.¹⁷²

or the production of income. Personal, living, and family expenses are generally non-deductible. See I.R.C. § 262(a). Deductions are allowed for some narrowly defined, purely personal items. See, for example, IRC § 163(h), which allows the deduction of qualified residence interest, IRC § 164(a)(1), which allows the deduction of state, local and foreign real property taxes, and IRC § 213, which allows the deduction of expenses for medical care. However, the deduction of these items may be limited. For example, only extraordinary medical expenses are deductible. IRC § 213(a) provides that there shall be allowed as a deduction the medical expenses paid during the year, not compensated for by insurance, to the extent that such expenses exceed 7.5% of adjusted gross income. I.R.C. § 213(a). Most personal deductions are itemized deductions, which are subject to reduction for high income taxpayers, under IRC § 68. Section 68 is an overall limitation on itemized deductions, which reduces itemized deduction by the lesser of three percent of the taxpayer's gross income over the applicable amount or 80%. The applicable amount of \$100,000 is adjusted annually for inflation. See I.R.C. § 68.

166. See I.R.C. § 162(a).

167. See generally Heen, *supra* note 111; Allan J. Samansky, *Child Care Expenses and the Income Tax*, 50 FLA. L. REV. 245 (1998); Brian Wolfman, *Child Care, Work, and The Federal Income Tax*, 3 AM. J. TAX POL'Y 153 (1984).

168. 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940).

169. See *id.* at 1039.

170. See *id.* The taxpayers attempted to deduct the expense of hiring a nursemaid to care for their infant child as an ordinary and necessary business expense under the Revenue Act of 1936, section 23(a).

171. *Id.* at 1040.

172. See Tax Reform Act of 1976, Pub. L. 94-455, § 504(a)(1), 90 Stat. 1563 (1976).

The current deductibility of child care expenses depends on who incurs the cost. Child care is considered an ordinary and necessary cost of doing business for an employer, who is entitled to deduct the cost of building and operating a child care facility. However, for the private household employer, child care is treated as a mere luxury unrelated to the production of income. The disparate treatment afforded individual child care expenses is more troubling when the individual is saddled with the responsibility of functioning as an employer for employment tax purposes. Imposition of employment tax requirements should entitle the individual employer to the same deduction for employing a child care as a corporate employer. This is not to suggest that individuals should be allowed to deduct the cost of maintaining a child care facility for their own children, but that a limited deduction is justified when an individual taxpayer is required to function as a provider of child care services for purposes of paying employment taxes.

2. *Salary Deduction for Wages Paid to Child Care Employees.*—The treatment of child care expenses as inherently personal, or as an expense incurred by a taxpayer in carrying on a trade or business, has received ample scholarly consideration. And while the personal versus business dichotomy is relevant in determining the deductibility of child care, it does not adequately address the issues particular to domestic employers. The question that must be answered is, whether a justification exists for treating the domestic employer/employee relationship differently from other employer/employee relationships.

Reasonable salaries that are incurred in connection with a taxpayer's trade or business are deductible from gross income.¹⁷³ The expenses must be directly related to the conduct of a trade or business and not just expenses like child care, which enable the taxpayer to go to work.¹⁷⁴ However, salaries need not be incurred in connection with an ongoing trade or business to be deductible. IRC § 212 provides for the deduction of salary expenses incurred by the taxpayer for the production or collection of income.¹⁷⁵

173. IRC § 162(a)(1) provides that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries and other compensation for personal services actually rendered." I.R.C. § 162(a)(1) (West Supp. 1998).

174. There is no provision in the IRC that permits the deduction of child care expenses unrelated to the production of income. A limited child care credit is provided under IRC § 21 to enable the taxpayer to work. I.R.C. § 21.

175. IRC § 212 provides that an ordinary and necessary expense may be deducted from income if it has been paid or incurred during the taxable year: (i) for the production or collection of income that will be included in the taxpayer's gross income; (ii) for the management, conservation, or maintenance of property held for the production of income; and (iii) in connection with the determination, collection, or refund of any tax. I.R.C. § 212. The Department of Treasury regulations refer specifically to the deduction of salaries by providing that fees for clerical help paid or incurred by the taxpayer held by him are deductible if they are paid for the production or collection of income, for the management, conservation, or maintenance of investments held by him, and are ordinary and necessary. Treas. Reg. § 1.212-1(h) (1998).

In *Higgins v. Commissioner*,¹⁷⁶ the IRS disallowed a deduction for salaries paid to clerical help and other fees associated with an office Higgins maintained to manage his personal investments.¹⁷⁷ The clerical workers retained in the *Higgins* case opened his mail and forwarded financial statements to him in France where he lived half of the year.¹⁷⁸ The clerical workers did not provide investment advice with respect to his stock trading and/or other financial dealings.¹⁷⁹ The United States Supreme Court disallowed the deduction, finding that the taxpayer's frequent investment activities were insufficient to overturn the decision of the Board of Tax Appeals that Higgins was not carrying on a trade or business.¹⁸⁰

The congressional reaction to *Higgins* was negative,¹⁸¹ prompting enactment of IRC § 212, which allows the deduction of expenses incurred for the production and collection of income, or for the maintenance of income-producing property unconnected to any trade or business carried on by the taxpayer.¹⁸² Section 212 and the accompanying Treasury Regulations expressly permit the deduction of salaries paid for clerical help for the management of personal investments.¹⁸³

There is no basis for distinguishing between salaries paid for carrying on a trade or business, salaries paid to clerical help for the management and conservation of income producing assets, and salaries paid to child care providers. Each of these employment relationships is treated the same for employment tax purposes.¹⁸⁴ Denial of a deduction for salary paid to domestic employees is supported only by the inequities caused by allowing some taxpayers to deduct child care expenses while others, who are often in lower tax brackets, cannot. However, permitting a taxpayer to take a salary deduction for the management of personal investments because he can afford to pay someone to

176. *Higgins v. Commissioner of Internal Revenue*, 312 U.S. 212 (1941).

177. *See id.* at 214. Higgins also held rental real estate that was managed by the same office. The expenses associated with the rental property were allowed as trade or business expenses. *See id.* at 215. However, the fees associated with the management of the investment portfolio were disallowed based on a finding that although the taxpayer's personal investment activities were extensive, regular and continuous, they did not amount to a trade or business. *See id.*

178. *See id.* The offices kept records, received checks, and made deposits as instructed by Higgins. *See id.*

179. *See id.* He sought permanent investments. Limited shifts in his investment portfolio were made under his direction. *See id.*

180. *Id.* at 218.

181. *See* JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 446 (10th ed., 1998).

182. I.R.C. § 212 (1994).

183. Treasury Regulation § 1.212-1(g) provides that fees for investment counsel, clerical help, office rent and similar fees incurred by the taxpayer are deductible if (1) they are paid or incurred by the taxpayer for the production of income or for the management, conservation, or maintenance of property; and (2) they are ordinary and necessary. Treas. Reg. § 1.212-1(g) (1998).

184. The only difference is that domestic employers are not subject to federal income tax withholding requirements.

open his mail provides a prime example of the inequities that are currently present in the IRC.

The current policy of treating the salary of women providing in-home child care as a personal luxury has had a detrimental effect on the market for domestic service.¹⁸⁵ The non-deductibility of child care expenses encourages household employers to cheat on their taxes by failing to report wages paid to household employees. This puts child care providers in an enviable position: They can, in fact, determine if they want to receive legal wages. When a worker's wages are deductible, the employer will report them to the IRS, regardless of how much the worker wants to be paid under the table.¹⁸⁶ On the other hand, the non-deductibility of wages perpetuates wage depression and allows an underground, often illegal, labor market to thrive.

A salary deduction for in-home child care providers legitimizes the employer/employee relationship. Treating child care workers as "real" employees lifts the veil of secrecy that shrouds domestic service. Implementation of a federal tax policy that recognizes domestic work as employment, and domestic workers as employees, is the first step toward nannies gaining parity with other workers with respect to pay, benefits, and working conditions.

CONCLUSION

The devalued status of domestic work is reflected in laws that fail to provide domestic workers with benefits afforded to other workers. Disregard for the interests of domestic workers is reflected in a federal tax policy that fails to enforce federal employment tax requirements and treats salaries paid to domestic workers differently from salaries paid to workers who provide labor outside of private homes. Absent the grant of true employee status to domestic workers, they will continue to be denied the employment benefits to which every laborer is entitled.

185. See Frum, *supra* 89 (theorizing that the market for domestic servants is choked by two pressures, one economic, the non-deductibility of child care expenses, the other cultural).

186. See *id.* Because a secretary's wages are deductible, the employer will report them even if the secretary would be preferred to be paid under the table. But when a nanny asks to be paid under the table, the employer loses nothing by winking at the illegality. See *id.*

