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Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business Advisor℠

September 2012

Dealing With Household Employees

Parents of young children often hire helpers, especially if both spouses work. You might need someone to watch the children and do various household chores, including cooking and cleaning.

When your children are old enough to care for themselves and perhaps do some of those tasks, your need for household help may end—but not forever. As you go through life, you might have to hire people to care for an elderly family member or one whose health is failing.

Payments and paperwork

Household workers, of course, must be paid. If those payments reach certain threshold levels, you must file tax forms and comply with applicable tax laws, as described in the following examples. You'll have to obtain an employer identification number and pay employment taxes.

Example 1: Adam and Nicole Benson hire a nanny for their two children. Because they pay her more than the $1,800 threshold in 2012, the Bensons must withhold and pay both Social Security and Medicare tax. Typically, those taxes total 15.3% of a household employee's wages, but the total is only 13.3% of wages in 2012.

Example 2: Jay Martin's wife, Helen, comes home from the hospital after a serious accident. The Martins hire a home aide to help Helen recover. During the fourth quarter of 2012, because the Martins pay the aide more than the $1,000 threshold in a calendar quarter, they must pay federal unemployment tax: 0.6% of a household employee's wages on wages up to $7,000 per year.

These two examples are not mutually exclusive. If the Bensons pay their nanny over $1,000 in any quarter this year, they also must pay federal unemployment tax. Similarly, if the Martins pay the home aide over $1,800 in 2012, they also must withhold Social Security and Medicare taxes. Moreover, whenever you hire a household employee to work for you on a regular basis, you and the employee must complete the U.S. Citizenship and Immigration Services (USCIS)

continued on page 2

What's Inside

Senior Sunset

Among Americans 65 or older, 8.5% spent at least one night in a nursing home in 2010, compared with 6% of the 65-and-up age group who stayed in a nursing home in 2000.

continued from page 1

Trusted Advice

Employment Eligibility

- No later than the first day of work, household employees must complete the employee section of the U.S. Citizenship and Immigration Services "Employment Eligibility Verification," Form I-9.
- Employers must complete the employer section of Form I-9 by examining documents presented by the employee as evidence of his or her identity and employment authorization.
- Acceptable documents to establish identity and employment authorization appear on the last page of Form I-9.
- Employers must retain the completed Form I-9 for either three years after the date of hire or one year after the date employment is terminated, whichever is later.

Form I-9, "Employment Eligibility Verification."

There are some exceptions to these rules. For instance, you won't owe these payroll taxes if you hire your own child and if the child is under age 21. In addition, state taxes also may be a concern.

Over (not under) the table

The official rules, as spelled out in the previous paragraphs, may run into human obstacles. Many household workers prefer to be paid in cash, off the books. They might report little, if any, income and, thus, avoid paying income as well as payroll tax. You, as a household employer, may be tempted to go along, saving the employer's share of payroll tax and cutting down on the paperwork burden.

If you avoid your responsibilities as a household employer, though, you are breaking federal and state laws. What's more, you may be leaving yourself open to severe financial consequences.

Example 3: Mary Edwards hired a nurse to care for her ailing husband. The nurse worked for Mary for many years under the radar. Mary never complied with any of the requirements described in this article. Years later, the nurse applied for Social Security and Medicare benefits, listing her years in the Edwards household as part of her work record. Mary eventually had to pay huge amounts of back payroll tax plus interest and penalties. There is no time limit on the ability of the IRS to demand unpaid payroll tax if the employer does not file an employment tax return.

Additionally, the money you spend on household employees may qualify for tax benefits, such as medical deductions and the child and dependent care credit. However, if you claim such deductions and credits, a subsequent audit of your income tax return might reveal a failure to file required returns and pay the tax relating to hiring household employees. Again, the total amount you could owe, counting interest and penalties, could be enormous.

Savvy solutions

If you hire household employees, you're required to comply with all the rules and pay the appropriate taxes. Instead of coping with all the forms yourself, you can seek expert assistance.

One approach is to deal with an agency when you need a housekeeper, home aide, etc. The people who will come to your home will be employees of the agency; the agency will bear all of the employer responsibilities, so you won't have to do so. You will have to pay the agency fees, though, and that can be expensive.

Another tactic is to call in a company that specializes in payroll reporting and recordkeeping. A payroll service company can help you deal with all the paperwork in order to help ensure that you comply with IRS regulations and pay your household employees' appropriate federal and state tax requirements. Moreover, our office can help you deal with the tax filing requirements. ■

Taxes on Gambling Winnings

For gamblers, the tax code offers unfavorable odds. Win, and you owe tax at your ordinary income rate, now as high as 35%. Lose....and you lose. There is no tax benefit.

However, savvy gamblers can offset taxable winnings with their losses if they can document those losses. The better your recordkeeping, the less tax you'll ultimately owe if you should happen to get lucky.

House rules

Casual gamblers (that is, persons not in the trade or business of gambling) should report any gambling winnings on line 21 of Form 1040 under "other income." Those winnings include money won at a casino or race track. Lotteries, bingo, raffles, etc., are all considered gambling, so you must report any success in those areas.

Example 1: Paul Sawyer wins $1 million in the lottery, payable over 20 years. In 2012, Paul sells the rights to his future payments for

$400,000. On his 2012 tax return, Paul reports $400,000 of gambling winnings. (If Paul had chosen to receive $50,000 per year, he would report $50,000 on his 2012 tax return.) According to cases such as *U.S. v. Maginnis*, decided by the Court of Appeals for the Ninth Circuit in 2004, money received from such a sale is taxed as ordinary income, so sellers won't get the favorable tax rate on long-term capital gains.

You'll also owe tax if you win a prize instead of cash. Typically, the entity awarding the prize will put a fair market value on the car, trip, or other item and report that to the IRS on Form 1099. You'll owe tax on the reported amount. If you think the value is overstated, you can report a lower amount, but you should be ready to support your claim to the IRS, if challenged. For example, make sure you can prove you sold the "$2,000 flat screen TV" you won to an unrelated third party for $1,200 immediately after you received it.

Reporting and withholding

Tax payers are supposed to report gambling winnings, like all forms of income, in full. To help enforce compliance, the gaming establishment must report certain winnings to the IRS on Form W-2G. For example, winnings (not reduced by the wager) of $1,200 or more from a slot machine must be reported; the same is true for winnings (reduced by the wager or buy-in) of more than $5,000 from a poker tournament. In many cases, 25% will be withheld and sent to the IRS on winnings over $5,000.

Taxpayers who do not provide a Social Security number when requested may be subject to 28% backup withholding.

Regardless of whether anything was withheld, you must report all of your gross gambling winnings on line 21 of Form 1040. This is not where you net your gambling winnings and losses.

Listing your losses

In order to get any tax benefit from gambling losses, you must itemize deductions on Schedule A of Form 1040. If you take the standard deduction instead, you'll owe tax on the full amount of your gambling winnings.

On Schedule A, you can list all your gambling losses. In effect, this will trim the tax on your gambling winnings. You can claim losses up to the amount of gambling winnings you report. Keep in mind, though, the trade-off is not perfect because gambling winnings increase your adjusted gross income (AGI), and a higher AGI may reduce your ability to claim various tax deductions and credits.

Example 2: Joan Miller reports $10,000 of poker winnings on line 21 of her 1040. On Schedule A, Joan claims $6,000 of losses from poker, other table games, and horse racing bets. In effect, Joan winds up paying tax on $4,000 of gambling winnings. ■

Did You Know?

You do not have to withhold income tax on wages paid to household employees unless the employee asks for it, and you agree to it. The employee should complete Form W-4, "Employee's Withholding Allowance Certificate," to help you determine how much income tax to withhold.

Source: Paychex, Inc.

Exploring the World of Exchange-Traded Funds

Less than two decades ago, the first exchange-traded fund (ETF) was launched in the United States. By now, there are more than 1,200 ETFs here with total assets over $1 trillion. ETFs may or may not belong in your portfolio; if you understand them, you can make an informed decision.

Standard model

The early ETFs were stock index funds (that is, they would hold shares of corporations included in stock indexes, so the ETFs would track those indexes). An S&P 500 Index ETF, for example, owns companies such as Apple and ExxonMobil in proportion to their presence in the index.

Investors can choose from a host of index mutual funds, so why choose an ETF? Generally, ETFs have lower expense ratios than index mutual funds, and lower expenses can enhance long-term performance.

continued on page 4

continued from page 3

Due to their structure, ETFs are less likely than mutual funds to generate unexpected taxable gains for investors. Moreover, ETFs trade like individual stocks, so investors may have the flexibility to use the tactics open to stock investors: sell short, use stop loss orders, buy on margin, and trade listed options.

Beyond the norm

Over the past 20 years, different types of ETFs have evolved. Some remain so-called "index" ETFs because they track an index rather than let managers buy and sell selected stocks. However, those indexes may have been created just so investors can participate in an obscure but potentially rewarding corner of the stock market. To cite one example, the WisdomTree Emerging Markets Equity Income Index tracks an index of high-yielding, dividend-paying stocks from places like Taiwan, Brazil, South Africa, and Malaysia.

Other ETFs depart from basic indexing. There are ETFs that track the price of gold, for example, and ETFs that follow commodity options strategies. Inverse ETFs go up when a particular index goes down; leveraged ETFs might move twice as much as an index or a commodity price, up or down.

Counting commissions

There is no magic to the ETF structure. Instead, it is a way to put together investments that have both risks and potential rewards. You should proceed cautiously and invest only if you are confident you know how a particular ETF is designed to perform.

In addition, keep in mind that you'll buy and sell ETF shares from and to other investors. You don't deal directly with the sponsoring financial firm as you do with mutual funds. You typically trade ETFs through a broker, and you'll pay commissions on each trade.

Therefore, if you rely on a broker's advice when you invest, you may wind up paying significant commissions on each ETF trade. You can cut costs by trading with a discount broker, but then you'll probably have to make your own investment decisions. ■

TAX CALENDAR

SEPTEMBER 2012

September 17

Individuals. If you are not paying your 2012 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2012 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2011 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2012. Use the worksheet Form 1120-W to help estimate tax for the year.

Partnerships. File a 2011 calendar year tax return (Form 1065). This due date applies only if you were given an additional five-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.

S corporations. File a 2011 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

OCTOBER 2012

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2011, file Form 1040, 1040A, or 1040EZ, and pay any tax, interest, and penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2011 calendar year tax (Form 1065-B).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2012. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 13 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

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