How to Reduce Your Nanny Taxes

Good news! Here are seven ways to reduce your nanny taxes that can save both you and your employee money.

1. Dependent Care Flexible Spending Account (FSA)

A Dependent Care FSA – offered through your employer – sets aside pretax money from your paycheck to help pay qualified, out-of-pocket childcare costs like your nanny's wages. You can contribute up to $5,000 as an individual or as a married couple filing jointly, or $2,500 for a married person filing separately. Depending on your tax bracket, you can save a few thousand dollars by using a Dependent Care FSA when employing a nanny.

2. Child and Dependent Care Tax Credit

The wages you pay your nanny are a qualified expense for the Child and Dependent Care Tax Credit. For the 2022 tax year (returns filed in 2023), the Child and Dependent Care Tax Credit returns to $3,000 in expenses for a family with one child and $6,000 for families with two or more children. You can typically take 20 percent of your expenses as a credit. That means $600 for one child or $1,2000 for two or more children.

3. Qualified Small Business Health Reimbursement Arrangement (QSEHRA)

It is true that by offering health benefits to your nanny that you can reduce your nanny taxes. A QSEHRA reimburses your nanny for health insurance coverage purchased on the individual market or through the health care exchange and/or for out-of-pocket medical, dental, and vision expenses. You can fund the QSEHRA up to $5,850 for a nanny who is single and $11,800 per employee with a family (2023 contribution rates). Those contributions are not taxed for you or your employee. Reimbursements for your nanny are also not taxed.

4. Individual Coverage Health Reimbursement Arrangement (ICHRA)

ICHRAs are like QSEHRAs as they are both employer-funded health reimbursement arrangements (HRAs) that reimburse employees tax-free for health insurance premiums and/or medical expenses. The money contributed by a family to an ICHRA is also not subject to employer taxes. The major difference between the two options is that there are no annual contribution limits with an ICHRA while QSEHRAs are restricted to a set amount each year.

5. Flexible Spending Account (FSA)

Flexible spending accounts are funded by an employee with pre-tax dollars up to $3,050 annually. Funds are used to pay for certain medical and dental expenses for the employee, their spouse, and their dependents. Since money is taken out on a pre-tax basis, an employee's taxable income is reduced meaning both the employer and the employee may be able to lower their tax responsibility.

6. Educational Expenses and Student Loans

As an employer, you can make tax-free payments of up to $5,250 per year toward your worker's qualified educational expenses such as tuition and textbooks. Through 2025, student loans are also considered a qualified educational expense. Payments toward an employee's qualified educational loans can be excluded from your worker's taxable income, lowering their gross wages and resulting in tax advantages for both you and your nanny.

7. Qualified Transportation and Parking Expenses

Your employee can aside $300 (2023 contribution rate) in pre-tax dollars each month for transportation expenses and that same amount for parking expenses. This reduces their gross income and lowers both their and your tax obligations. Transportation expenses include public mass transit (subway, train, buses, ferries, etc.) passes, tokens, fare cards, and vouchers as well as vanpooling. Driving expenses such as tolls and gas are not qualified expenses and are not eligible for pre-tax reimbursement.

Have questions about reducing your nanny tax obligation? Get a complimentary, no-obligation consultation with a household employment expert by calling (800) 929-9213.