Planning to Minimize Social Security and Self-Employment Tax

by C. Allen Bock

About the author: C. Allen Bock is an attorney at law and a professor of agricultural law in the department of economics, University of Illinois, Urbana-Champaign. He and his family are also involved in the Angus business; Bock Angus is located in Fisher.

The Social Security Tax Act of 1982 imposes an increasing burden on the social security and self-employment taxes. There are, however, some planning opportunities to reduce the increasing burden of these taxes.

The direct effect of the 1982 Act is an increasing tax rate for both the social security and the self-employment tax. The social security tax impact is shown in Table 1.

Refundable credit

For 1984, the effective rate for employees after a credit equal to 0.3 percent of the compensation subject to social security is 6.7 percent. The combined rate is therefore 13.7 percent for 1984.

Wage base

For 1984, $37,800 is the wage base—the income subject to social security tax. This wage base will be recalculated in the future to reflect the increase in the consumer price index. The wage base applies both to employees and to self-employed individuals. The 1983 wage base was $35,700.

Table 2 shows the rates for self-employed individuals. 1984 and later year rates for self-employed individuals have been increased (from the 1983 combined rate of 9.35 percent) to equal the combined employer and employee contributions. The increase is partially offset by a credit against the tax. This scheme is illustrated in the table.

The self-employment tax

The self-employment tax is paid on the net earnings of a trade or business. For farmers and ranchers this is generally the net profit shown on the bottom line of the tax form, Schedule F. The tax, for 1984, is paid on the first $37,800 of net earnings from the trade or business.

In order to be liable for self-employment tax, the owner of the business must actually be operating the business or must be "materially participating" in the management of the trade or business. The Farmer's Tax Guide (IRS Publication 225) explains the four tests for material participation as follows:

You are materially participating if you have an arrangement with your tenant for your participation and you meet one of the four following tests.

- You do any three of the following: (1) advance, pay or stand good for at least half the direct costs of producing the crop; (2) furnish at least half the tools, equipment and livestock used in producing the crop; (3) consult with your tenant; and (4) inspect the production activities periodically.
- You regularly and frequently make, or take an important part in making management decisions substantially contributing to or affecting the success of the enterprise.
- You work 100 hours or more spread over a period of five weeks or more in activities connected with crop production.
- You do things that, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.

These tests may be used as general guidelines for determining whether you are materially participating. For further information, contact your Social Security office. Doubtful cases may be submitted to the District Director of Internal Revenue for advice.

Table 1. Rates for Employers and Employees. The following table includes the rates that apply to employee withholding and employer contribution, as well as the combined rate.

Year	Old Age, Survivors and Disability Insurance (%)	Hospital Insurance (%)	Combined (%)	Combined Employer and Employee (%)
1984	5.70	1.30	7.00	14.00
1985	5.70	1.35	7.05	14.10
1986	5.70	1.45	7.15	14.30
1987	5.70	1.45	7.15	14.30
1988	6.06	1.45	7.51	15.02
1989	6.06	1.45	7.51	15.02
1990 & later	6.20	1.45	7.65	15.30

Table 2.

Taxable year beginning in	Old Age, Survivors and Disability Insurance (%)	Hospital Insurance (%)	Combined (%)	Tax on $37,800 before credit	Credit	After Credit
1984	11.40	2.60	14.0	$5,292	$1,021	$4,271
1985	11.40	2.70	14.1	5,330	869	4,461
1986-87	11.40	2.90	14.3	5,405	756	4,649
1988-89	12.12	2.90	15.02	5,678	756	4,922
1990 & later	12.40	2.90	15.30	5,783	See below	

Credit: 1984—2.7 percent of self-employment income up to maximum base
1985—2.3 percent of self-employment income up to maximum base
1986 to 1989—2 percent of self-employment income up to maximum base
1990 and later years—self-employed persons will be allowed a deduction (attributable to a trade or business) of one-half of the self-employment taxes paid. Alternatively, they may deduct from self-employment earnings an amount equal to 7.65 percent of net earnings from self-employment.

Maximum self-employment tax 1983 = $3,378
Maximum self-employment tax 1984 = 4,271
Actual maximum increase = $ 893

Wage payment to spouse or children

If you are a sole proprietor (not a corporation and not a partnership unless the partnership is solely owned by mother and father), wages paid to a spouse or to a son or daughter, under age 21 at the end of the calendar year, are not subject to social security taxes.

The wages paid have to be reasonable for the services performed, services must be actually performed and detailed records kept.

Many farm and ranch wives provide labor for the business but are not paid a wage. The following example shows the effect on the husband's self-employment tax on a wage to the wife for services to the business.

Net farming or ranching income before payment	$25,000
Self-employment tax before payment	$2,825
Salary wife at $6,000	
Net farm income after payment	$19,000
Self-employment tax after payment	$2,147
Self-employment tax savings	$678

The payment to the wife does not directly save any income taxes because the $6,000 would be included as income on the joint tax return. However, the $6,000 wage in this example does qualify for the IRA retirement contribution and therefore up to $2,000 of the payment can be sheltered from income tax until paid out at retirement.

A payment to a child does provide potential income tax savings because the parents' taxable income is reduced by that amount and generally the child will pay tax on the wage at a lower rate than the parents.

Payment in kind

Social security tax does not have to be paid on payments that are other than in cash for agricultural labor. So, wage payments to agricultural labor in grain or livestock are not subject to social security tax. This technique could be used for children who are working on the farm or ranch but are over age 21 or for other agricultural labor if the goal is to reduce social security tax liability.

If the wife is not materially participating in the operation, her share of the income (landowner's share) is generally not subject to self-employment tax and should be reported on another schedule.

It is important to recognize that whenever social security or self-employment tax payments are reduced through planning techniques, benefits available through the social security system may likewise be reduced.

When payments are made in kind and not in cash, the following conditions should be met:

1. Physical possession of the grain or livestock should be given rather than a paper transaction.
2. You should avoid pre-arranged sales for employees' products with those of the employer.
3. The employees should be instructed to decide the time, place and terms of the sale rather than simply adding them to your marketing activity.

Your tax counselor may also want to review Revenue Ruling 79-207.

Division of income between spouses

Husbands and wives frequently own land individually or as joint tenants or tenants in common, yet all the land is operated as one unit. Generally, the income from this unit is reported on one Schedule F and the husband pays self-employment tax on the entire net amount. If the wife is not materially participating in the operation, her share of the income (landowner's share) is generally not subject to self-employment tax and should be reported on another schedule (Form 4835). This division has the potential of reducing self-employment tax. For example:

> Husband and wife own 200 acres as tenants in common. The wife does not materially participate in the business. The net income for 1984 is \$20,000. If the wife reports her landlord's share (\$5,000) on Form 4835 this creates a \$5,000 reduction in the husband's net income subject to self-employment tax. A \$5,000 reduction in self-employment income for the husband creates a \$565 savings in self-employment tax.

Alternate business structure

In some instances, operating through an S corporation or a C corporation can reduce social security tax liability by reducing the amount of the business income subject to the tax. See your tax counselor about this concept because many other significant tax and legal considerations are critical to this decision.

Loss of benefits and taxation of benefits

If it is not your first year of retirement (the rules are somewhat different in that year) and you are age 65 but under age 70, you can earn up to \$6,960 in wage or business income in 1984 without losing social security benefits. Income that is classified as passive income, like interest, rent, dividends, and farm or ranch income, where you are not the operator and are not materially participating in management, does not count toward the \$6,960 limit. For every dollar of income over \$6,960 you earn through wages or active involvement in a trade or business, you lose \$.50 of social security benefits.

Once you reach age 70, your benefits are not reduced regardless of the level of such earnings.

Taxation of social security benefits

Starting in 1984 social security and railroad retirement benefits will be included in gross income but the inclusion is limited to the lesser of: a) one-half of the benefits received, or b) half the excess of the sum of the taxpayer's adjusted gross income, interest on tax-exempt obligations and half the social security benefits over the base amount. (\$32,000 for persons filing jointly, \$0 for married persons filing separately, and \$25,000 for all other individuals.)

1984 Example:

Social Security benefits received (joint return)	\$14,000
Adjusted gross income	\$38,000
Tax-exempt interest	\$2,000

Lesser of: a) half the benefits (\$7,000)
b) \$38,000 + \$7,000 + \$2,000 (\$47,000) less \$32,000 (\$15,000) ÷ 2 = \$7,500

Answer: \$7,000 (the lower of A or B) of the benefits of this couple will be included in gross income in 1984.

Summary

There are opportunities available to minimize the increasing social security and self-employment tax. However, these opportunities have to be analyzed in the light of present savings and their value over time when compared with the potential loss of ultimate benefits from the social security system. Consult your attorney or tax counselor to analyze the opportunities and their effect on your personal situation. AJ