EC-869



SEPTEMBER 1985

# Social Security Taxes and Tax Management



**Billy B. Rice**
Farm Management Economist
Extension Service

**David Saxowsky**
Assistant Professor
Agricultural Economics Department

The Social Security program was initiated in 1936 to ease the economic hardship of retired workers. Since then it has been expanded to cover survivors and disabled workers and provide Medicare. Similarly, persons required to contribute to the system and the rate at which they are taxed also have increased. The maximum annual social security tax which a self-employed individual could pay was $126 in 1955. In 1985, the maximum is $4,672.

A recent study found that self-employment is one of the largest tax obligations of North Dakota farm operators, second only to real estate taxes. Therefore, farmers should have a clear understanding of who pays social security taxes, which income is taxed and at what rate, when to withhold from employees, and recent changes in the law. Farm families should also be aware of management strategies that allow the most coverage at the least possible cost.

This circular provides an introduction to social security taxes and explains the 1983 changes in those tax laws. It should not be used as a substitute for professional advice. Consult your accountant, the Internal Revenue Service or your local Social Security Administration office for answers to specific tax questions.



## Who Pays Social Security Taxes?

Most workers pay social security taxes. Exceptions include federal employees hired prior to January 1, 1984, who pay for Civil Service retirement, or employees of a state or local government that has established an approved alternate mandatory retirement system.

If you are self-employed, you must pay social security taxes unless you are a nonresident alien, an exempted member of the clergy, or your net earnings for the year are less than $400. Self-employment social security taxes are figured on Schedule SE and filed with your Form 1040.

## What Income Is Taxed?

Most earned income is subject to the social security tax. Income is considered earned if it results from your labor or is profit from a business. It does not include earnings from investments. Examples of income not usually subject to social security taxes are:

- Dividends from shares of stock.
- Interest on savings accounts, loans or bonds.
- Rental income from real estate, including farmland as long as the landlord does not take a significant part in the farm's production or management.
- Income received by a limited partner who performs no service for the partnership.
- Capital gains and losses.
- Wages paid to you by your spouse.
- Wages paid by a parent to a child under the age of 21.
- Gifts and inheritance.

The maximum income subject to social security taxes is called the "wage base." For 1985, the social security wage base is $39,600. Earnings over this amount are not subject to the tax. The wage base is indexed to the average wage of U.S. workers and is adjusted each January 1.

## What Are The Social Security Tax Rates?

Two social security tax rates exist, one for employees and one for self-employed individuals. In 1985, as an employed individual, you are paying the

* Information in this circular was adapted for North Dakota from an Agricultural Planning Guide written by R.L. Plain, Department of Agricultural Economics, University of Missouri.

COOPERATIVE EXTENSION SERVICE
North Dakota State University Fargo, North Dakota 58105

equivalent of a 14.1 percent tax on your wages. Your employer pays half and you pay half (Table 1).

The self-employed social security tax rate equals the combined employer-employee rate. However, the effective tax rate for self-employed individuals is reduced by a credit. This credit is 2.3 percent for 1985, which reduces the effective rate to 11.8 percent. Social security tax rates are scheduled to increase in 1986, 1988, and 1990.

**Table 1. Social Security Tax Rates.**

| | Employed | | Self-Employed | | |
|---|---|---|---|---|---|
| | Employer Rate | Employee Rate | Rate | Credit | Effective Rate |
| | | ---------Percent--------- | | | |
| 1985 | 7.05 | 7.05 | 14.10 | 2.3 | 11.8 |
| 1986 | 7.15 | 7.15 | 14.30 | 2.0 | 12.3 |
| 1987 | 7.15 | 7.15 | 14.30 | 2.0 | 12.3 |
| 1988 | 7.51 | 7.51 | 15.02 | 2.0 | 13.02 |
| 1989 | 7.51 | 7.51 | 15.02 | 2.0 | 13.02 |
| After 1989 | 7.65 | 7.65 | 15.30 | * | * |

* After 1989, the self-employed credit will be replaced by a deduction designed to equate self-employed taxes with the combined employee-employer taxes.

## Relation of Benefits to Taxes

The relationship between social security taxes and social security benefits is complex. In general, social security retirement benefits depend upon:

**Years of taxes paid.** In order to receive social security payments, you (or sometimes a family member) must have credit for a certain amount of work under the social security system. Social security credits are called "quarters of coverage." Anyone born after 1928 needs 40 quarters of coverage in order to receive social security retirement benefits. People born before 1929 need one quarter less than 40 for each year they were born prior to 1929.

The procedure for determining quarters of coverage has varied with time. Prior to 1978, employees received one quarter of coverage for each calendar quarter in which they were paid wages of $50 or more. For 1985, workers and self-employed individuals earn one quarter of coverage for each $410.00 of annual earnings, up to a maximum of four quarters per year. The $410.00 amount will increase each year as average earnings increase.

**Amount of taxes paid.** The amount of your retirement benefits is directly related to the amount of income on which you pay social security taxes.

**Age at which you begin collecting benefits.** You cannot receive social security retirement benefits prior to age 62 but postponing until age 65 entitles you to receive a larger monthly payment.

**Other income.** Active earnings may cause a reduction in your social security check.

For more detailed information on social security benefits contact a social security office or call toll free in North Dakota 1-800-342-4570.

## Withholding On Employees

Your employer withholds your portion of the social security tax from your paycheck. He then remits both his portion and your portion of the tax to the IRS.

If you employ a farm worker, you must withhold social security taxes for that worker if the individual is 1) paid $150 or more in cash wages during a calendar year or 2) works for cash wages on a time basis for any part of 20 days during a calendar year. You are not required to withhold social security taxes or income taxes on independent contractors although you may be required to furnish a statement of income to the IRS (Form 1099-MISC).

## Taxes On Your Benefits

Prior to 1984, social security benefits were not taxable. Now, as much as half your social security benefits may be included in your taxable income. You will have to pay federal income taxes on part of your social security benefits if your adjusted gross income plus your non-taxable interest income plus half of your social security benefits equal more than a base amount.

The base amount for a single individual is $25,000. For a couple filing jointly, the base is $32,000. A married couple filing separately has a base of zero if they lived together at any time during the year.

To determine how much of your social security benefits will be included in your taxable income, subtract the applicable base amount from your combined income. Your combined income is calculated by adding your adjusted gross income, your nontaxable interest income and half your social security benefits. Half of this difference is taxable; but remember, no more than 50 percent of your benefits will be taxed.

**Example:** Married couple filing jointly has adjusted gross income of $27,000, nontaxable interest income of $4,000, and Social Security benefits of $7,200.

| | Example | Your Figures |
|---|---|---|
| 1. Adjusted gross income | $27,000 | ______ |
| 2. Nontaxable interest | 4,000 | ______ |
| 3. ½ of annual social security benefits | 3,600 | ______ |
| 4. Total (lines 1 + 2 + 3) | 34,600 | ______ |
| 5. Applicable base | −32,000 | ______ |
| 6. Difference (line 4 − 5 but not less than 0) | 2,600 | ______ |
| 7. Taxable social security benefits (½ of line 6 but no greater than line 3) | 1,300 | ______ |

## TAX MANAGEMENT

### Splitting Income

Farming is usually a family business. Husband and wife often co-own the property and are both involved in making decisions and doing farm work. If the farm makes a profit, what is the best method of reporting the income? Should all of the income be reported in the husband's name or should it be split between the husband and the wife? Generally, it is all reported in the husband's name leaving the wife's account without benefits because little or no taxes have been contributed to it. The consequence of one spouse without social security contributions is that should that spouse die or become disabled, there would be no benefits for surviving or dependent family members. Splitting the income between husband and wife assures that both spouses are accumulating a record for social security benefits.

In order to divide the income, the business must be operated as a true partnership or joint venture. Otherwise, all income is reported in the name of the spouse conducting the trade or business.

The manner in which the income is divided can make a difference in the amount of tax owed. If both spouses have income, they may be eligible for the federal 10 percent marriage deduction for two-wage-earner couples. A disadvantage to splitting income occurs in high-income years, because the social security wage base applies to each spouse.

The manner in which business income is divided between spouses also makes a difference in future social security benefits. If only one spouse pays self-employment taxes on all the farm income, that spouse's potential retirement and disability benefits will be higher. However, dividing the income and paying self-employment taxes on both the husband and the wife will allow both to establish a social security record and potentially qualify for benefits on their own records.

Remember, you may receive retirement benefits based solely on the record of your spouse. You may also qualify for retirement benefits based on your own work record as well as that of your spouse. In that instance, you receive the larger of the two amounts, not the combined benefits. However, disability benefits are based entirely on your record only.

### Hiring Family Members

You might be able to save income taxes and social security taxes by hiring your spouse and children to work in your family business. Table 2 illustrates the possible tax savings.

**Table 2. Hiring Family Members**

| | Husband | Wife | Child | Total |
|---|---|---|---|---|
| **Case I** | | | | |
| Income | $36,000 | 0 | 0 | $36,000 |
| Federal Income Tax | 5,481 | * | 0 | 5,481 |
| North Dakota Income Tax | 575 | * | 0 | 575 |
| Social Security Tax | 4,248 | 0 | 0 | 4,248 |
| Total Tax | 10,304 | 0 | 0 | 10,304 |
| **Case II** | | | | |
| Income | $28,000 | $4,000 | $4,000 | $36,000 |
| Federal Income Tax | 4,427 | * | 63 | 4,490 |
| North Dakota Income Tax | 465 | * | 7 | 472 |
| Social Security Tax | 3,304 | 0 | 0 | 3,304 |
| Total Tax | 8,196 | 0 | 70 | 8,266 |

* Married filing jointly.

Assume a husband, wife and child younger than 19 operate a family farm that is their only source of income. In 1985, the farm made a profit of $36,000 when no charge is made for family labor.

In Case I, the entire farm income is reported in the husband's name for social security taxes. The husband and his wife, filing jointly, pay $5,481 in federal income tax and $575 in North Dakota income tax. The husband also pays $4,248 in self-employment tax for a total tax bill of $10,304 (Table 2).

In Case II, the husband pays his wife and child $4,000 each for the work they do on the farm. This $8,000 in hired labor reduces the taxable farm income to $28,000. The tax bill is now changed even though total family income remains at $36,000. The husband and his wife, filing jointly, now pay $4,427 in federal income tax and $465 in North Dakota income tax on their combined earnings of $32,000. The child pays $63 in federal income tax and $7 in North Dakota income tax. The husband pays $3,304 in self-employment taxes. Neither the wife nor the child pay social security taxes because wages paid by one spouse to the other or by a parent to a child under 21 are exempt from social security taxes. The total tax bill is only $8,266, a net savings of $2,038. An added benefit is that the wife can now qualify for her own individual retirement account.

As this example illustrates, you can save money by paying your spouse or child for work which they do. The wages, however, must be reasonable and appropriate for the work performed. These wages do not count toward receiving social security benefits.

## Wages Versus Profits

Most farms are sole proprietorships. As such, a farmer cannot pay himself a wage for his own labor. When the farm makes a profit, the entire profit up to the wage base is subject to self-employment social security tax.

If the farmer were to incorporate, he would be an employee of the corporation and would be paid a wage. Social security taxes would be paid on the wage earned, not the corporate profit. As a result, incorporation may be one method for profitable farms to reduce social security taxes.

Incorporating will increase the social security taxes of an unprofitable farm, however. A sole proprietorship that has a loss owes no social security taxes. Once incorporated, you must pay social security taxes on wages, even though the corporation may be suffering big losses.

## Treatment of Expenditures

Business expenditures that are deductible for income tax purposes reduce earned income which, in turn, results in lower self-employment tax. By comparison nonbusiness expenditures, although they may reduce income taxes, will not decrease self-employment tax even for persons who itemize their personal deductions. Accordingly, business owners will want to properly treat their expenditures for tax purposes and be certain to record and be able to substantiate each business expenditure made during the year.

**Example:** Interest paid on a loan to purchase farm assets (for example, a tractor) is deductible on schedule F. Such interest expense reduces both income taxes and social security taxes. Interest paid on a loan to buy personal items (for example, a television set) is deductible on schedule A. This interest expense will reduce income taxes (if the taxpayer itemizes) but does not reduce social security taxes.

## Shifting Income

Farmers normally do not pay social security taxes on rental income or income from the sale of capital assets such as land, machinery, or breeding livestock. Management strategies which substitute these sources of income for other farm income will usually reduce your social security taxes. For example, under certain conditions, a wife who does not materially participate in the farm business may be able to rent her portion of the farm assets to her husband and thereby reduce the family's social security taxes.

## Increasing Your Social Security Taxes

You might sometimes wish to pay higher social security taxes, not lower taxes. For example, you must pay into social security for a certain period before becoming eligible for benefits. So it might be prudent to try to pay some social security taxes rather than to avoid them entirely. (See the optional method below).

The amount of your retirement check also is determined in part by the amount you paid in social security taxes. It may be desirable for some to increase their social security taxes in order to increase their base for benefits.

## The Optional Method

If your total self-employment income is less than $400, you owe no social security taxes. However, an optional method allows self-employed individuals with minimal gross income to pay some social security tax and thereby gain credit toward future benefits. If a farmer's self-employment income is less than $1,600 and his gross farm income is more than $2,400 he can pay social security taxes on $1,600. If gross farm income is less than $2,400, the individual may pay self-employment taxes on two-thirds of the gross farm income. Farmers may not use the optional method if the gross farm income is less than $600. A similar option is available to nonfarm businesses.

## Social Security: Not A Savings Plan

Social Security is not a savings program. Social security taxes collected are paid out immediately to others in benefits. Since it is not actuarially sound, it is not an insurance program.

Social security takes income from workers and gives it to the retired and disabled. The amount take—social security taxes—and the amount given—social security benefits—depend on the relative size with accuracy is difficult. Both will continue to change. You should not rely solely on social security for disability or retirement income. All workers should develop their own savings and insurance plans.

## Additional Information

For additional information on the social security system, write or visit any social security office. The address of the nearest office is listed in your telephone book under Social Security Administration.

Cooperative Extension Service, North Dakota State University of Agriculture and Applied Science, and U. S. Department of Agriculture cooperating. Myron D. Johnsrud, Director, Fargo, North Dakota. Distributed in furtherance of the Acts of Congress of May 8 and June 30, 1914. We offer our programs and facilities to all persons regardless of race, color, sex, religion, age, national origin, or handicap; and are an equal opportunity employer.