THE SELF-EMPLOYMENT TAX: AN UNCHANGING FLOOR

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ABSTRACT

This paper explores some of the history of social security and Medicare taxes, including the self-employment tax. The $400 floor on self-employment income can lead to situations where the marginal self-employment tax is larger than the marginal self-employment income. The floor is discussed, and some possibilities for changes in the tax law are presented.

INTRODUCTION & HISTORICAL BACKGROUND

Since 1951, most self-employed individuals in the United States have paid a self-employment tax. An individual is not liable for this tax in a year that his/her adjusted net income from self employment is less than $400. This paper explores some of the history of social security and Medicare taxes, including the self-employment tax. The $400 floor on self-employment income is discussed in detail. This floor can lead to situations where the marginal self-employment tax is larger than the self-employment income. Some possibilities for changes in the tax law to resolve this problem are presented.

The Great Depression led to legislation in the United States to provide for more security for employees. The tax provisions of the Social Security Act are known as the Federal Insurance Contributions Act (FICA). The original social security tax on both employers and employees, first levied in 1937, was 1 percent of the first $3,000 of an employee's earnings. The current tax on both employers and employees is 7.65 percent of earnings. Part of this tax, 6.2 percent of earnings, is a social security tax, and the other part, the remaining 1.45 percent, is a Medicare tax. These rates have gradually increased over time since the original 1 percent tax, but the rates have not changed since 1990. The social security tax has a maximum wage base on which it is levied. This wage base has increased from the original $3,000 to the 2007 maximum wage base of $97,500. Since 1994, there has been no maximum wage base for the Medicare tax [2].

The original social security legislation did not cover self-employed workers. However, the Social Security Act Amendments of 1950 included the Self-Employment Contributions Act (SECA) which provided for a tax on self-employed people so they could also be covered under the social security benefits in existence for employees. In 1951 when the SECA tax was first levied, the tax rate for self-employed individuals was higher than the rate for employees because self-employed individuals did not have any employer to provide a matching contribution. However, the rate for self-employed individuals was not twice the rate for employees. Since 1984, the SECA tax rate has been twice the rate for employees. Thus, self-employed individuals are subject to a rate equivalent to both the employer and employee portions of the combined social security and Medicare taxes (15.3 percent).

Starting in 1990 two adjustments made SECA taxes more comparable to the FICA taxes paid by employers and employees. The first adjustment is that self-employed individuals are allowed to multiply their unadjusted net earnings for self-employment by 0.9235 before calculating the self-employment tax. The second adjustment is that self-employed individuals are allowed to subtract onehalf of their SECA tax as deduction for AGI on their income tax returns. Since the inception of the SECA tax, a $400 floor has existed. If an individual's self-employment income is less than $400 for a particular year, no SECA tax is levied for the year. "The reason for the $400 floor was to ensure that a self-employed individual received four quarters of coverage [credits] for Social Security purposes" [1, p. 342]. Another reason for the floor also exists. "The $400 floor also serves the purpose of administrative convenience because it exempts from self-employment tax those individuals with a very small (*de minimus*) amount of self employment income" [1, pp. 342-3]. The only change to the $400 floor since 1951 is the adjustment allowed starting in 1990 to multiply unadjusted net earnings from self-employment by 0.9235 to determine adjusted net earnings from self-employment. Since it is this adjusted earnings from self-employment that is subject to the $400 floor, an individual can actually have unadjusted self-employment income of any amount less than $433.13 ($400/0.9235) without being subject to SECA tax for a given year. Other than that one change which apparently was not targeted at the $400 floor, the exact same floor has been in effect for over 55 years.

PROBLEM WITH $400 FLOOR & POTENTIAL SOLUTIONS

It is difficult to argue that self-employed taxpayers "deserve" this floor for SECA taxes. It is true that no floor exists for employees who are subject to the FICA tax. However, because the floor for SECA taxes does exist and has existed for over 55 years, it does present a problem in some cases. Because the $400 is a floor rather than an exemption amount, those with self-employment income just above the floor have an extremely high marginal SECA tax rate. For example, an individual with unadjusted self-employment income of $430 will have no SECA tax liability for the year because after multiplying $400 by 0.9235, the result is less than $400. However, an individual with just $10 more in unadjusted self-employment income will owe SECA tax for the year of $62.17 ($440 x 0.9235 x .153). Ten dollars more in self-employment income increased SECA taxes by over $60!

Several possibilities exist for resolving the problem with the SECA tax income floor. One argument is that the floor should simply be eliminated to make the SECA tax more comparable to the FICA tax for low-income employees. However, this may be inappropriate because of the administrative costs involved. Another argument is that since the floor has been $400 for more than 55 years, an increase in the floor amount should be considered. It could be increased in any of a number of different ways:

1. Use a $600 floor because that is the limit used for companies reporting on a 1099-MISC form for services performed for a trade or business by people not treated as employees.
2. Use a $1,000 floor (indexed for future years) because $1,000 of self-employment income would earn one credit toward social security benefits.
3. Use a $4,000 floor (indexed for future years) because $4,000 of self-employment income would earn the maximum of four credits per year toward social security benefits.
4. Use a floor based on the consumer price index (indexed for future years), calculating the appropriate change since 1951. Using this index, the floor would be $3,160 in 2007.
5. Use a floor based on the average wage index (indexed for future years), calculating the appropriate change since 1951. Using the index up through 2005, the current self-employment income floor would be $5,280.
6. Tie the self-employment income floor to the filing requirements for the income tax return since the SECA tax is reported on that form. For example, for 2007 those who can be claimed as dependents on someone else's return do not have to file unless their earned income exceeds $5,150 (assuming no or only nominal unearned income).

Any increase in the self-employment income floor would have a revenue impact on the government because fewer individuals would be paying the SECA tax. In addition, if any of these methods were used, the problem mentioned above would still exist. Individuals with self-employment income just above the floor could have marginal self-employment taxes in excess of the marginal income earned to trigger any SECA tax. Therefore, any attempt to increase the floor should probably only be considered for the purpose of administrative convenience if the cost/benefit breakeven for administering this tax occurs at a higher level than the current $400 floor.

Some other methods could be used to overcome the stated problem, either with or without a change in the floor amount. The examples will be illustrated with the current $400 floor amount, but they could easily be changed if a larger floor amount is assumed.

1. Instead of having a $400 floor amount, change it to a $400 exemption.
2. To avoid as much loss of revenue to the government as would occur in the prior suggestion, the floor could become an exemption amount but only for select groups. For example, the floor could be an exemption for low-income taxpayers (defined either in terms of some low level of self-employment income or in terms of some low level of AGI on the income tax return.)
3. Phase in the self-employment tax for those with self-employment income above the floor so the marginal SECA tax rate would always be well below 100 percent. For example, if the floor remained at $400, instead of making all self-employment income immediately subject to SECA tax as soon as it is above the floor, double the SECA tax rate for self-employment income between $400 and $800. If a 30.6 percent rate were applied to all self-employment income in this range, by the time the individual had self-employment income of $800, he/she would have paid a SECA tax equivalent to 15.3 percent of the first $800 of self-employment income. The rate could then drop back to 15.3 percent for any additional self-employment income. This way, no individual would have a marginal self-employment tax rate above 30.6 percent, and all individuals with self-employment income above $800 would be paying the full 15.3 percent tax on all of their self-employment income.

CONCLUSION

The floor on self-employment income has been $400 for over 55 years even though prices, wages, and other indexes have increased many times in that same time period. Although it might be appropriate to increase the $400 floor on self-employment income for paying SECA taxes, the major argument supporting such a move would only exist if the administrative costs in processing the tax exceed the tax generated at some amounts above the current floor. Different suggestions were given that would (1) make the $400 floor an exemption amount, either in general or for select groups, or (2) phase in the SECA tax so the marginal SECA tax rate would always be well below 100 percent. These suggestions would resolve the problem with the current SECA tax floor which can result in a marginal SECA tax which is larger than the marginal self-employment income.

REFERENCES

[1] Brazelton, Julia K., Alan D. Campbell, and Sharie T. Dow, *Tax Strategies for the Self-Employed*, Chicago: CCH Incorporated, 2000.

[2] Social Security Administration, “Table 2.A3–Annual maximum taxable earnings and contribution rates, 1937-2006,” Annual Statistical Supplement, 2006.