EMPLOYEE AND SELF-EMPLOYED: THE IMPLICATIONS OF TWO EMPLOYERS ON SELF-EMPLOYMENT TAXES

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ABSTRACT

This paper discusses the lack of continuity between how multiple employers of the same employee are treated with respect to Social Security taxes versus how they are treated if the individual employee is also self-employed. While a self-employed individual is treated as both the employee and employer, the treatment as a separate employer is only consistent when the total earnings are less than the Social Security annual maximum earnings base.

Keywords: Self-employment taxes, Multiple employers, Tax laws

INTRODUCTION

Self-employed individuals in the United States pay self-employment taxes for Social Security similar to the employment taxes paid by employees and employers for Social Security. Because self-employed individuals are considered to be their own employers, they pay both the employee and employer portions of the tax. The Social Security tax has a maximum earnings base on which it is charged each year, $127,200 for 2017. An employee only has to pay the tax on earnings up to this maximum each year. However, if someone has two employers, each employer would be responsible for the matching share of Social Security tax on all amounts paid to this individual up to the maximum earnings base. No coordination takes place to limit the total paid by these two employers from exceeding the limit paid by the employee. However, if someone has both employee income and self-employment income, the self-employment income is only subject to Social Security taxes until the total earnings from both employment and self-employment reaches the maximum earnings base. Thus, the employer of the self-employed individual is treated as a separate employer only to the extent that total earnings is below the maximum earnings base. This paper explores whether this coordination, as currently legislated, is appropriate.

SOCIAL SECURITY BACKGROUND

The Social Security Act of 1935 introduced payroll taxes and the concept of providing retirement income to retired individuals. Later additions to the program included benefits for dependents of retired workers and benefits for dependents of those who died before retirement age [7]. During the 1950s, different categories of self-employed individuals were added to this program, and self-employment taxes were first levied under the Self-Employment Contributions Act of 1954 (SECA) [2]. Disability insurance was also added during this decade [5]. The combined Social Security tax rates started at 1.0%, but rose gradually over time to the current combined rate of 6.2% for both the employer and the employee. Since those who are self-employed pay both portions, the Social Security tax rate for these individuals is 12.4%. These rates have been constant since 1990, with a slight modification for two years—2011 and 2012. A maximum earnings base also exists on which Social Security taxes are paid each calendar year. The maximum earnings base in 1937 was $3,000, but it has increased over time up to $127,200 for 2017 [6].

The employee and employer Social Security tax is due on the employee's earnings from employment. The self-employed pay the Social Security tax on net earnings from self-employment (NESE). NESE is calculated by starting with the gross earnings from self-employment minus any trade or business deductions attributable to the business [1]. An additional deduction is allowed in calculating net earnings from self-employment. This deduction is equal to one-half of the SECA tax rates multiplied by the net self-employment income before this deduction [1]. Since the SECA taxes consist of the 12.4% Social Security tax and the 2.9% Medicare tax, the deduction mentioned is for 7.65% [(12.4% + 2.9%) x ½ = 7.65%]. See Smith and Smith [3][4] for how this deduction is miscalculated mathematically.

PERSPECTIVES ON SOCIAL SECURITY

At least three different perspectives of what Social Security is or should be exist. A discussion of these perspectives is relevant, as it may affect how someone looks at the treatment of Social Security taxes for an individual who has both employee and self-employment income. One perspective is that Social Security is a retirement/pension program. Defined benefit pension plans promise specific payments to the employee during retirement, often based on years of service and earnings during the employment period. However, these plans are also designed to be funded such that the invested contributions and income will be adequate to pay the promised benefits to retired employees. Social Security is similar to a defined benefit retirement plan, but it is not funded by assets invested to guarantee the promised payments; it is instead funded on a pay-as-you-go basis. A second perspective is that Social Security is a government welfare program. Most welfare programs have some type of means testing. In other words, benefits received by an individual are based on need, not on any specific taxes or contributions paid by that individual. In these cases, the funding/taxes providing the welfare benefits are collected from society as a whole and redistributed to those with needs.

A third perspective views Social Security as a government-sponsored insurance program. Social Security is, in some ways, an insurance plan, as it provides income to insure against loss of income (retirement benefits), loss of life (survivors' benefits), and loss of health (disability benefits). It also resembles an insurance plan from the viewpoint that premiums are paid in (employee and employer contributions) without a specific expectation that benefits received will be directly proportional to the premiums paid in. Because benefits received from the Social Security program may be more or less than the contributions to the program, this program does resemble a type of insurance, albeit an involuntary insurance. Perhaps the Social Security program does not match any one of these perspectives exactly. It seems to include and exclude characteristics from each of the perspectives.

COORDINATION OF SOCIAL SECURITY TAXES FOR THOSE WHO ARE EMPLOYEES AND SELF-EMPLOYED

Each employee's share of the 6.2% Social Security tax is limited to the annual maximum earnings base, no matter how many employers he/she has. If multiple employers withhold Social Security taxes for the same individual and the total earnings on which the tax was withheld exceed the earnings base, the employee can claim the excess Social Security tax withheld as an income tax payment when filing the annual income tax return. For example, if an employee has two employers, each having paid the employee $75,000 of wages subject to Social Security taxes during the year, each employer will have withheld

$4,650 [$75,000 x 6.2%] for this employee's Social Security taxes. Since the maximum Social Security tax for this employee for 2017 would be $7,886.40 [$127,200 x 6.2%], the employee would be able to claim the excess Social Security tax withheld on the income tax return for that year. Employers have to match the 6.2% Social Security tax withheld from employees' pay (up to the maximum earnings base) and submit both the employee and employer portions to the government, a total of 12.4%. However, if an employee has more than one employer with neither employer paying more than $127,200 in wages to the individual but with the employers' combined wage payments exceeding $127,200, these employers cannot claim a refund for the "excess" paid from a combined perspective. In other words, the Social Security earnings base applies to an individual for total wages earned, but it applies to each separate employer for each individual employee, regardless of whether that employee has multiple employers.

Self-employed individuals pay Social Security taxes at 12.4%, twice the 6.2% rate. However, if a self-employed individual also has employee earnings, and the employee earnings plus the self-employment income exceed the maximum earnings base, that individual should not have to pay the employee's share of the Social Security tax on amounts exceeding the earnings base. Theoretically, though, the self-employed might still be required to pay the employer's share of the Social Security tax on any amount of self-employment income up to $127,200, as the "employer" of the self-employed individual is a separate employer from any other employer paying wages to the individual. The current tax law for calculating self-employment taxes does not require self-employed individuals who have employee earnings to pay the employer's share of the Social Security tax on any amount of self-employment income that causes the total of the employee earnings plus the NESE to exceed the maximum earnings base [1]. For example, if someone has employee earnings greater than $127,200 in 2017 and also has some self-employment income, no Social Security portion of the self-employment taxes would be would be levied against this individual for the year. However, if the individual had only $100,000 of employee earnings in 2017 but also had some self-employment income, the individual would be liable for the Social Security portion of the self-employment taxes, 12.4%, both the employee and employer share, for any NESE above $100,000 until the total amount of earnings plus NESE reached $127,200. Why is the employer of a self-employed individual only considered a separate employer up to the point where employee earnings and self-employment income reach the maximum earnings base?

DISCUSSION

At least three options are available to respond to this issue. First, current laws and applications could remain as they are. Second, laws could be changed so that multiple employers of the same individual would be treated as one employer such that, combined, they would only pay the employer's share of the Social Security tax for that employee up to the maximum earnings base for the year. Third, laws could be changed to treat the employer of a self-employed individual as a separate employer, with the employer's share of Social Security due for any amount of self-employment income up to the maximum earnings base, regardless of any separate employee earnings.

With the first option, no change to current tax law would be required. Current law provides an advantage to some of those who have both employee earnings and self-employment income. If the total of these earnings is less than the maximum earnings base, then Social Security taxes, both the employee and employer portions, are paid on the total amount. However, if the total of these earnings is above the maximum earnings base, the self-employed individual avoids paying the employer share of the Social Security taxes on the portion of any self-employment income that causes the total earnings to exceed the maximum earnings base. This result may not be totally fair if a comparison is made to someone who has two separate employers. Two separate employers do not get an advantage if their total wages for this individual exceed the maximum wage base for the year, even though their individual wages for this individual do not. However, the employer of a self-employed individual is only treated as a separate employer up to the point where total employee earnings plus NESE equals the maximum earnings base.

If someone only has self-employment income, then the employer's portion of the Social Security tax is paid on all NESE up to the maximum earnings base. However, if someone with self-employment income also has a separate employer, then the employer's share of the Social Security portion of the self-employment tax may be reduced in some cases. For example, if an accounting faculty member earns a salary of $100,000 from a university and also has an opportunity to prepare some tax returns or do some consulting for an additional $10,000, the Social Security taxes on the extra self-employment earnings would be $1,145.14 [12.4% x $10,000 x 92.35%]. However, if the faculty salary were $120,000, the additional Social Security tax for self-employment would be only $892.80 [12.4% x ($127,200 - $120,000). If the faculty salary were $135,000, no Social Security tax would be due on the self-employment income. The 2.9% Medicare tax would still be due on all NESE in each of these examples. Thus, for someone over the maximum earnings base as an employee, consideration of a separate self-employment opportunity would not be affected by the 12.4% Social Security portion of SECA taxes.

For someone who has both employee income and self-employment income, the part of the income which is perceived to be the primary job might also affect the framing of how additional opportunities are evaluated. For example, someone with employee income over the maximum earnings base who has an opportunity for some nominal marginal income through self-employment might simply evaluate the option as having no additional Social Security tax consequences, as the maximum will already be paid through the employee/employer employment taxes. However, someone with NESE over the maximum earnings base who has the opportunity for some marginal income through an employment opportunity might evaluate the option as reducing the Social Security portion of the self-employment taxes by 12.4% while only increasing the employee share of the Social Security tax on the employee income by 6.2%.

Having multiple employers continue to pay Social Security taxes for one individual who has, in total, earned more than the maximum earnings base for the year, seems to be more like a welfare program than a retirement or insurance program. Revenues for the program come from wherever possible, even if they will have no direct connection to the benefits an individual will earn for the extra contribution on behalf of that individual. While those additional program revenues benefit the Social Security funding, they do not increase the benefits promised to that individual employee. On the other hand, if the employer of a self-employed individual is not treated as a completely separate employer to the full extent of the maximum earnings base, the government loses out on potential Social Security revenues. So this part of the policy seems to be closer to a retirement program where contributions made are more closely tied to the benefits earned by the individual for whom the contributions are paid.

The second option would not change the Social Security tax paid by those who are both employees and self-employed. However, it would provide an advantage for employers who have employees with multiple employers when the total wages between employers exceeds the maximum earnings base. These employers could get a refund if the total amount paid on behalf of a specific employee for the year between/among multiple employers exceeded the annual maximum. Using the example introduced earlier, suppose that an employee earned $75,000 from each of two different employers in 2017. Each employer would have paid $4,650 [$75,000 x 6.2%] for its matching share of the Social Security tax. The total contributed by employers on behalf of this employee, $9,300, would be over the maximum amount that should be paid on behalf of one employee for the year, so they would each get a refund for the excess paid proportionate to the amount of wages paid. Of course, this would reduce the net amounts contributed by employers to the Social Security trust funds. Since these funds are already in financial difficulty, it is very unlikely that this option would find any political support. This option would treat employers of employees similar to employers of the self-employed. The total contributions made on behalf of an individual each year, both by the employee and the employer(s), would be limited to amounts that will directly increase the benefits earned by that individual. While this option may not be politically palatable, there are some fairness issues involved where the self-employed who also have employee income get a possible reduction of total employer Social Security taxes paid when compared to multiple employers of one individual.

A focus of this option is the individual and the possible Social Security benefits earned by the contributions made, both by the individual and the employers. If the individual is the focus, then total Social Security taxes paid for the year should be reflective of the credit that individual can earn toward future Social Security benefits. A counterargument can be presented here that unemployment taxes are paid per employee per employer per year, not just per employee per year. For example, if an employee switches employers during the year, each employer may have to pay the federal unemployment taxes on the first $7,000 of employee earnings for the employee that year. If multiple employers can each be required to pay the maximum unemployment taxes on the same individual, why not treat Social Security taxes the same way? However, unemployment taxes are an employer-only tax, not an employee tax. While unemployment taxes may help fund unemployment benefits for individuals, the unemployment tax is paid to protect the employer's liability for unemployment benefits. The unemployment tax has an employer focus, not an individual employee focus. In addition, since those with multiple employers during a year are, in some cases, those who claim unemployment benefits, it makes more sense to have an employer focus on unemployment taxes and have each employer pay up to the maximum unemployment taxes for the year, even if multiple employers are paying for the same individual. However, taxes on employment should not have the same focus as unemployment taxes, so it may make more sense to focus employment taxes on the individual rather than the employer. If the individual becomes the focus, with multiple employers limited, in total, to the maximum contribution for any single individual, this option resembles more of an insurance program.

The third option would change the Social Security taxes paid by those who are self-employed but also have employee income. Those individuals would only have to pay the employee share of the Social Security tax up to the maximum earnings base for the year. However, they would pay the employer share of the Social Security tax for all NESE up to the maximum earnings base regardless of any employee income. Of course, this option would substantially increase the Social Security tax for some individuals, leading to an increase in the government revenues for the Social Security program. For example, if an individual has $100,000 of employee income and $100,000 of NESE, the total Social Security tax paid by this individual under current law would be $9,572.80 [($100,000 x 6.2%) + ($27,200 x 12.4%)]. The employer would also contribute $6,200 [$100,000 x 6.2%], leading to a total paid for this individual for the year at $15,772.80. Under the possible change, this individual would pay $14,086.40 [($100,000 x 6.2%) + ($27,200 x 6.2%) + ($100,000 x 6.2%)]. The employer would also contribute $6,200 [$100,000 x 6.2%], leading to a total paid for this individual for the year at $20,286.40. The possible increase in Social Security taxes under this option is significant. This proposal would increase Social Security tax payments for anyone who has some NESE if the employee income plus NESE exceeds the maximum earnings base. In the extreme case, it could increase an individual's Social Security tax by $7,886.40 [$127,200 x 6.2%] for someone who had at least $127,200 of employee earnings and also had at least $127,200 of NESE.

For someone who has both employee income and self-employment income, the part of the income which is perceived to be the primary job would not affect the framing of the decision in the same way as was mentioned previously under current laws. For example, someone with employee income over the maximum earnings base who has an opportunity for some nominal marginal income through self-employment income would need to evaluate the option considering the additional 6.2% Social Security tax (only the employer portion), as the maximum employee Social Security tax will already have been paid through employee withholdings. Likewise, someone with NESE over the maximum earnings base who has the opportunity for some nominal marginal income through an employment opportunity would also need to evaluate the option considering the 6.2% employee Social Security tax on the employment income. This third option would bring parity between how multiple employers are treated versus how the employer of the self-employed is treated if there is also an employer for that same individual. No increase in taxes is politically popular, even if it increases the parity in the way similar groups are taxed. However, if the focus moves away from the individual and toward the employers, the program again resembles more of a welfare program than a retirement or insurance program.

Individuals who would be affected by this increase in Social Security taxes might change their behavior when considering additional self-employment opportunities because it could change the net marginal benefit of additional work. For example, if an accounting professor who has a salary of $135,000 were considering an additional work opportunity for consulting or tax return preparation for a few hundred or a few thousand dollars, the marginal SECA taxes would be 9.1% [2.9% + 6.2%] of any NESE rather than just 2.9% of any NESE. If this faculty member were offered a $1,000 consulting opportunity, current tax law would require SECA taxes of only $26.78 [$1,000 x 92.35% x 2.9%] on this amount. However, the proposed option would increase the SECA taxes, now including the employer share of Social Security taxes, to $84.04 [$1,000 x 92.35% x 9.1%], an increase of $57.26 or 5.73% of the contracted amount.

A possibility exists that some self-employment opportunities would be rejected because the increase in taxes means the work is not worth doing for the amount of the contract. Another possibility is that the amount charged for the self-employment work would go up so the after-tax benefit would still be the same. It is also possible that additional self-employment opportunities would be sought out to make up for the loss in additional Social Security taxes to keep the after-tax income constant. While a lot of self-employment income is documented through 1099 tax forms, other self-employment work is not so documented. If the marginal tax rates increase for those who are employed and self-employed, it is also possible that the temptation to hide self-employment income would increase, both for self-employment tax purposes and for income tax purposes.

CONCLUSION

Current law with respect to Social Security taxes treats those who are self-employed as both the employee and the employer. Thus, the self-employed pay twice the Social Security tax rate paid by employees, as employees have employers who are matching the contributions. However, this treatment is not consistent when comparing employees with multiple employers with employees with one employer who also have self-employment income, at least for those whose employee earnings plus NESE exceeds the Social Security maximum earnings base for a given year. This paper presents some possible alternatives to the current tax law, which would treat multiple employers of one individual similarly.

REFERENCES

References available upon request from Sheldon R. Smith.