

Social Security: The Sometimes Forgotten Issue at Tax Time

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If someone were to come to you and say "You have \$500,000 to invest over your lifetime; figure out to get the best return," you would put considerable thought and effort into the process.

Social Security should be no different. With the present social security rates at approximately 15.3% in addition to federal and state income taxes, a self-employed person with above-average earnings could easily pay \$500,000 in self-employment taxes over his/her lifetime. You might say, "Well, there's nothing I can do about paying that money; I have no other choice." For most workers and some self-employed individuals, this is true, but for farmers and many other self-employed persons the opposite is true - how much is paid in and, thus, what benefits will be upon retirement is controllable and can be managed. In order to manage your social security taxes and subsequently your benefits, a strategy must be developed that takes into account more than a dozen variables specific to each individual.

An individual's earning history is obviously the most significant factor when determining Social Security benefits. When one has a long, consistent earnings history, further earnings may actually produce a lower return of future benefits or possibly even no return at all. This occurs because, by law, only a certain number of years may be used to compute a person's benefits. Once this number has been reached, each additional year of earnings eliminates the lowest year in the person's computation years.

For example, an individual, age 59, is a shareholder in a family farming corporation. He has done very well over the years and at the time was drawing a wage of \$15,000 from the corporation. Upon performing an analysis, it was determined that the increased benefits from his current year's wage was zero because the lowest year in the person's earnings was just under \$17,000 after indexing. Since he had posted the maximum number of years in calculating his benefits, the lowest earnings year being eliminated was the current one. The self-employment or social security taxes paid on \$15,000 is approximately \$2,295 which would be paid by the corporation and the individual. Of the \$2,295 paid into the Social Security fund, this individual would receive zero dollars in retirement benefits-the money is gone.

Substantial control exists over the amount of self-employment taxes paid into Social Security. This control comes from a taxpayer's ability to 1) structure income from forms subject to Social Security to those that are not subject to Social Security taxes (ex. capital gains or rental income); and/or 2) use tax-planning techniques to lower income in an absolute sense.

For a sole proprietor (an individual who operates a business as a sole owner), Social Security taxes are computed on net income generated and reported on a Schedule F for

farmers and Schedule C for small business. There are several things sole proprietor farmers or business can do to legally shift income from a form subject to Social Security taxes to one which is not. The most common of these would include:

- paying a spouse or employee in non-cash wages.
- paying children under 18 for work performed in the family business.
- gifting grain or other commodities to family member.
- shifting recognition of income from Schedule C or F to capital gains income.

Thus, with the realization that self-employment taxes are controllable, Social Security strategies can be easily implemented. The lay process in planning your strategy is as follows:

1. Identify your position regarding Social Security by a request to Social Security for earnings and some competent advice from professionals.
2. Consider other relevant variables that affect your planning between now and retirement. These include the status of your spouse, potential for passing the business onto the next generation, where you are in your business and, finally, what alternatives exist for your business and other resources between now and retirement.
3. With a clear picture of your position, lay out what you would like to have happen on a short and long-term basis. Consider not only Social Security, but other means of planning your retirement income.
4. Finally, implement your strategy using available tax provisions. This needs to be done in concert with a skilled tax professional.

It has become vitally important for self-employed individuals to develop an awareness and a strategy of how they can maximize their returns from the Social Security system. The sheer magnitude of Social Security tax contributions make potential savings in this area very significant in relation to the total amount of taxes paid. Depending on a person's age, marital status, and past Social Security earnings, self-employment or FICA taxes can be a bargain for the potential coverage received, or they can be an investment that produces a negative return.