DESCRIPTION OF THE SOCIAL SECURITY TAX BASE

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SOCIAL SECURITY
of the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The Subcommittee on Social Security of the House Committee on Ways and Means has scheduled a public hearing for June 23, 2011, on Social Security's finances. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief overview and legislative history followed by a brief description of the present-law tax base of the Social Security system.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Social Security Tax Base* (JCX-36-11), June 21, 2011. This document may also be found on our website at www.jct.gov.

I. OVERVIEW AND BRIEF LEGISLATIVE BACKGROUND

In general

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages.[2] Payroll taxes include the Federal Insurance Contributions Act ("FICA"), the Self-Employed Contributions Act ("SECA"), and the additional hospital insurance tax on certain high-income individuals.

FICA.—FICA imposes taxes on both employers and their employees based on the amount of wages paid to an employee during the year.[3] As discussed in greater detail below, the employer tax is comprised of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2011); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages. The employee tax is equal to the amount of tax imposed on the employer.[4] The employee tax generally must be withheld and remitted to the Federal government by the employer.[5]

SECA.—Self-employed taxpayers are subject to tax on their self-employment income under SECA. Like the FICA tax, the SECA tax has two components. Under the OASDI component, the rate of tax is 12.40 percent (10.4 percent in 2011 only) on self-employment income up to the Social Security wage base ($106,800 for 2011).[6] Under the HI component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base).[7]

The wage base for the FICA and SECA taxes is indexed each year automatically according to a statutory formula. As a result, an increase in average wages in the economy increases the wage base for purposes of the FICA and SECA taxes.[8]

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[2] Revenues from the income taxation of Social Security benefits and interest earnings on trust fund reserves are other sources of funding.

[3] Sec. 3111. Unless otherwise stated all section references are to the Internal Revenue Code of 1986, as amended.

[4] For 2011 only, the employee tax is 4.2 percent.

[5] The OASDI and HI payroll tax is generally collected as a single tax with portions of it allocated by statute among separate trust funds: the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund and the Supplementary Medical Insurance Trust Fund. 42 U.S.C. secs. 401, 1395i.

[6] Sec. 1401(a). In calculating the SECA tax for OASDI, the Social Security wage base taken into account is reduced by FICA wages paid to the individual during the taxable year.

[7] Sec. 1401(b)(1).

[8] The earnings base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment (COLA) formula. If there was no increase in benefits, the earnings base is prohibited from

Additional hospital insurance tax on certain high-income individuals.—For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages[9] received in excess of the threshold amount.[10] However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Income taxation of Social Security benefits.—Individuals with income above certain thresholds must pay income tax on the Social Security benefits they receive. The revenue raised from taxation of Social Security benefits also finances Social Security and Medicare. Revenues generated under the first tier of tax (those generated from the taxation of up to 50 percent of benefits) are dedicated to the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund, and any additional taxes from the second tier (those generated from the taxation of benefits beyond the initial 50 percent of benefits and up to 85 percent of benefits) are dedicated to the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund.

Persons covered by OASDI.—In 2010, approximately 156 million people worked jobs covered under the OASDI program. Approximately 93 percent of the U.S. workforce is covered by OASDI. Workers excluded from coverage include: (1) Civilian federal employees hired before January 1, 1984; (2) Railroad workers (who are covered under the railroad retirement system, which is coordinated with Social Security); (3) Certain employees of State and local governments who are covered under their employers' retirement systems; (4) Domestic workers and farm workers whose earnings do not meet certain minimum requirements (workers in industry and commerce are covered regardless of the amount of earnings); and (5) Persons with very low net earnings from self-employment, generally under $400 annually.[11] Currently, earnings of about 25 percent of State and local government employees are not covered under the OASDI program. This represents about four percent of the total U.S. workforce.

Legislative Background of FICA, SECA, and the Income Taxation of Social Security benefits

FICA and SECA as of 1975. —In 1975, the FICA tax on employers was comprised of the OASDI tax, at that time equal to 5.85 percent of covered wages up to the taxable wage base of $14,100, and the HI tax, equal to 0.9 percent of covered wages. Then, as now, each employee is

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increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011. When indexing restarts, the wage base will reflect wage growth from 2009 under the normal indexing rule.

[9] Sec. 3121(a).

[10] Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148.

[11] Social Security Administration, *Annual Statistical Supplement to the Social Security Bulletin, 2010* (Feb. 2011).

subject to FICA taxes equal to the amount of tax imposed on the employer. The SECA tax in 1975 was imposed on the same wage base as FICA and was composed of the same OASDI and HI components, but the rate was equal to 7.9 percent of the wage base (7 percent OASDI, 0.9 percent HI). While the taxable wage base since 1975 has generally been determined under a statutory formula, Congress provided for different taxable wage bases for taxable years 1979-1981.[12]

FICA payroll taxes were modified by the Social Security Amendments of 1983 (the "1983 Act").[13] Under the 1983 Act, coverage was extended on a compulsory basis to Federal employees,[14] members of Congress, the President and Vice-President, Federal judges, and employees of non-profit organizations. In addition, the 1983 Act also accelerated a previously enacted increase in the tax rate and made other changes.

The 1983 Act also raised SECA payroll taxes. Prior to the 1983 Act, SECA taxes had been deliberately set lower than FICA taxes. The 1983 Act sought to erase this discrepancy starting in 1984 with the goal of achieving parity between SECA and FICA by 1990. Therefore, effective in 1990, only 92.35 percent of self-employment income is taxable as "net earnings from self-employment"[15] and the self-employed taxpayer receives a deduction for 50 percent of SECA taxes paid.[16]

Also, as a result of the Omnibus Budget Reconciliation Act of 1990[17] the HI base was raised to $125,000 in 1992 and $135,000 in 1993.

As part of the Omnibus Budget Reconciliation Act of 1993,[18] the earnings base for the HI portion of the tax was removed, making all earnings taxable for HI purposes, effective in 1994.

Beginning in 1990, the OASDI tax rate has been 6.2 percent and the HI rate 1.45 percent for employee and employer, while for SECA taxes the OASDI rate has been 12.4 percent and the HI rate 2.9 percent.

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[12] Pub. L. No. 95-216.

[13] Pub. L. No. 98-2. High unemployment rates throughout the 70s as well as a decrease in real wages led to fears that the system would be vastly underfunded and a need to generate revenue quickly. The National Commission on Social Security Reform was created to address the issue, and its final report formed the basis for many of the 1983 amendments.

[14] If hired after December 31, 1983.

[15] This adjustment is made to reflect the fact that employees do not pay FICA taxes on the employer's portion of the FICA tax. Thus, the base is reduced by 7.65 percent, the employer's share of FICA taxes.

[16] This deduction mirrors the treatment for employees, who do not pay income tax on the employer's portion of the FICA tax.

[17] Pub. L. No. 101-518.

[18] Pub. L. No. 103-66.

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, for 2011 only the employee OASDI rate was lowered two percentage points to 4.2 percent and the SECA rate was lowered by two percentage points to 10.4 percent.[19]

Income taxation of Social Security Benefits.—The 1983 Act made OASDI benefits subject to income tax. Under the 1983 Act, up to half of OASDI benefits were made includable in taxable income for taxpayers with incomes above certain base amounts. As part of the Omnibus Budget Reconciliation Act of 1993, the maximum portion of Social Security benefits includable in taxable income was raised from up to half, to up to 85 percent.

[19] The revenue loss to the Social Security Trust Funds from the provision was replaced by a general revenue transfer.

II. SOCIAL SECURITY AND MEDICARE TAXES

A. Federal Insurance Contributions Act

In general

FICA imposes a tax on employers and employees based on the amount of wages paid to the employee during the year.[20] The tax imposed is comprised of two components: OASDI and HI.

Under the OASDI component, the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[21] The tax is imposed on covered wages up to the taxable wage base ($106,800 in 2011).[22]

Under the HI component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not limited by the amount of the taxable wage base.

Generally, covered wages means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Exceptions from this general rule apply under present law. [23]

The employee portion of FICA usually must be withheld and remitted to the Federal government by the employer.[24] The employer is liable for the amount of this tax whether or not the employer withholds the amount from the employee's wages.[25] In the event that the employer fails to withhold FICA from an employee's wages, the employee generally is not liable to the IRS for the amount of the tax. If, however, the employer pays its liability for the amount of the tax not withheld, the employer has a right to collect that amount from the employee. If the employer deducts and pays the tax, the employer is indemnified against claims and demands of any person for the amount of any payment of the tax.[26]

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[20] Sec. 3111.

[21] Sec. 3101. A special rule for 2011 temporarily reduces the employee tax rate for OASDI from 6.2 percent to 4.2 percent. Pub. L. No. 111-312.

[22] The taxable wage base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment ("COLA") formula. If there was no increase in benefits, the earnings base is prohibited from increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011 too. When indexing restarts, the wage base will reflect wage growth from 2009 under the normal indexing rule.

[23] These rules are described in detail below.

[24] Sec. 3102(a) and Treas. Reg. sec. 31.3121(a)-2.

[25] Sec. 3102(b).

[26] *Ibid.*

Additional tax on high income individuals

For taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, or $200,00 in any other case.[27]

As is the case for wages paid prior to 2013, the employer is required to withhold the additional HI tax on wages and is liable for the tax if it is not withheld from wages. However, in determining the employer's requirement to withhold and its liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account and the employer must disregard the amount of wages received by the employee's spouse. Thus, the employer is only required to withhold on wages in excess of $200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below $200,000 (for example, if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed $250,000). The employee is liable for the additional tax to the extent that it is not withheld by the employer.

Definition of wages

FICA applies to wages paid to an employee by an employer during the year. Wages subject to FICA generally include all pay, whether made in cash or in other forms, given to an employee for services performed.[28] Wages include salaries, vacation allowances, bonuses, deferred compensation, commissions, and fringe benefits. Amounts an employer pays as a bonus for signing or ratifying a contract in connection with the establishment of an employer-employee relationship and an amount paid to an employee for cancellation of an employment contract and relinquishment of contract rights are wages subject to FICA.

The Code, however, provides for numerous exceptions to the definition of wages that are subject to FICA. Several of the most prevalent exceptions are discussed below.

Payments not subject to FICA

Cafeteria plans

A section 125 cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits which are excludable from wages (and thus not subject to FICA).

Generally, a cafeteria plan may not include any plan that offers a benefit that defers pay. A cafeteria plan may, however, include a qualified 401(k) plan and certain life insurance plans maintained by educational institutions despite the fact that they defer compensation. Cafeteria plans may include adoption assistance, dependent care assistance, group-term life insurance

[27] Sec. 3101 as added by PPACA, Pub. L. No. 111-148.

[28] Sec. 3121(a).

coverage, flexible spending arrangements, and health savings accounts among other qualified benefits.

FICA does not apply to any payment made to, or on behalf of, an employee or his or her beneficiary under a cafeteria plan if: (1) the payment would not be treated as wages without regard to the plan, and (2) it is reasonable to believe that (if the cafeteria plan rules would apply for purposes of the definition of the term wages) Code Sec. 125 would not treat any wages as constructively received.[29]

Special rules apply to S corporation shareholders and cafeteria plans that favor highly compensated or key employees.

Fringe benefits

Generally, fringe benefits, such as employer-provided automobiles, vacations, discounts, and tickets to entertainment or sporting events, are considered wages and are subject to FICA. Subject to certain special valuation rules, the amount that must be included in wages is the amount by which the fair market value of the benefits exceeds the sum of what the employee paid for the benefit.

Some fringe benefits, however, are excluded from gross income if certain conditions are met.[30] There is a parallel exclusion from FICA if, at the time the benefit is provided, it is reasonable for the employer to believe that the benefit is excludable from gross income. Examples of nontaxable fringe benefits include no additional cost services, qualified employee discounts, working condition fringe benefits,[31] minimal value (de minimis) fringe benefits,[32] qualified transportation fringe benefits, qualified moving expense reimbursements, on-premises athletic facilities, and qualified tuition reduction by educational institutions. Nondiscrimination rules may apply to certain fringe benefits in order for them to be excluded from wages.[33]

[29] Sec. 3121(5)(G).

[30] Sec. 132.

[31] Working condition fringe benefits are property and services provided by an employer to its employees so that the employee can perform his or her job. Examples include an employee's use of the company car for business, and job-related education provided to an employee.

[32] De minimis fringe benefits are property and services provided by an employer to its employee whose value is so small that accounting for it is unreasonable of administratively impracticable. Examples include occasional typing of personal letters by a company secretary, local telephone calls, and occasional picnics for employees.

[33] Sec. 132(j).

Accident and health benefits

Employer contributions towards accident and health insurance for employees, their spouses, and dependents, are not considered wages and are not subject to FICA. Generally, this exclusion also applies for qualified long-term care insurance.

Employee achievement awards

Awards that are tangible personal property (excluding, for this purpose, cash, gift certificates, and securities), given to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and under circumstances that do not indicate that the payment is disguised compensation, are excluded from wages and are not subject to FICA to the extent that at the time provided it is reasonable to believe the award is not included in the employee's gross income.

In general, a maximum of $400 per year can be excluded for the cost of all employee achievement awards given to the same employee. There is a higher limit of $1,600 for awards that are given pursuant to a written plan that does not discriminate in favor of highly compensated employees ("qualified plan awards"). An award cannot be treated as a qualified plan award if the average cost per recipient of all awards under all qualified plans exceeds $400.

Moving expenses

Moving expenses that are paid under a qualified plan, and that would otherwise be deductible by the employee, are not considered wages unless the employer has knowledge that the employee deducted the expenses in a prior year.

Meals and lodging

The value of meals that are provided for the employer's convenience and on the employer's premises generally is not treated as wages and is not subject to FICA. Similarly, the value of lodging is not considered wages if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment. Whether meals or lodging are provided for the convenience of the employer is determined based on the totality of the facts and circumstances.

Differential wage payments

Differential wage payments are payments made by an employer to an employee for a period during which the employee is performing services in the uniformed services of the United States while on active duty for a period of more than 30 days.[34] The payments represent all or part of the wages the individual would have received from the employer if the individual were continuing to perform services for the employer. While differential wage payments are wages for purposes of income tax withholding, they are not considered wages for purposes of FICA.

[34] Sec. 162(a)(1).

Employee business expense reimbursements

An expense reimbursement arrangement is a system pursuant to which employers pay the advances, reimbursements, and charges for employees' ordinary and necessary business expenses.[35] Reimbursements and allowances paid under an "accountable plan" are not wages and are, therefore, not subject to withholding and employment taxes. In order to be an "accountable plan" an arrangement must meet the following requirements: (1) individuals must have paid or incurred the expenses while performing services in their capacity as employees, (2) the amount must have been paid for the expense and must not be an amount the individual would have otherwise paid; (3) the employee must substantiate expenses to the employer within a reasonable time frame; and (4) the employee must return any amount in excess of the substantiated expenses within a reasonable time frame. If expenses are not substantiated, or if amounts in excess of the substantiated expenses are not returned, they are treated as having been paid under a nonaccountable plan. Payments made under a nonaccountable plan are considered to be wages and are subject to withholding and payment of payroll taxes for the first payroll period following the end of a reasonable period of time.[36]

Relocating for temporary work assignments

If an employee is given a temporary work assignment away from his or her regular place of work, certain travel expenses reimbursed or paid directly by the employer under an accountable plan may be excluded from wages. Generally, a temporary work assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less. In addition, the new work location must be outside the city or general area of the employee's regular work place or post of duty, the travel expenses must otherwise qualify as deductible by the employee, and the expenses must be for the period during which the employee is at the temporary work location.

Health Savings Accounts ("HSAs") and Archer Medical Savings Accounts ("Archer MSAs")

Employer contributions towards HSAs and Archer MSAs are not subject to FICA if it is reasonable to believe at the time of the contribution that they will be excludable from the employee's income (i.e., that they will be used to pay for qualified medical expenses as defined in Code section 213(d)). To the extent it is not reasonable to believe the contributions will be excludible the amount will be included in wages and subject to FICA.

Employee contributions to an HSA made pursuant to a salary reduction arrangement under a Code section 125 cafeteria plan are not considered wages and are not subject to

[35] Ordinary and necessary business expenses are those that would otherwise qualify for a deduction by the employee. See Treas. Regs. secs. 1.62-2 and 31.3121(a)-3.

[36] Whether a period of time is "reasonable" is determined under the individual facts and circumstances, although certain safe harbors exist. See Internal Revenue Service, Publication 15: (Circular E), Employer's Tax Guide (2011).

employment taxes. Other employee contributions to their HSAs and Archer MSAs made through payroll reduction, however, are included in wages.

Medical care reimbursement

Generally, medical care reimbursements paid by an employer for an employee under an employer's self-insured medical reimbursement plan are not wages and thus are not subject to FICA.[37]

Per diem and other fixed allowances

Employees may be reimbursed for travel days, miles, and certain other fixed expenses. In these cases, the expenses are considered to have been adequately accounted to the employer (and thus, not considered wages) if the reimbursement does not exceed rates established by the Federal government. For example, the standard mileage rate for 2011 is 51 cents per mile. If the per diem or allowance exceeds the Federal amounts, the excess amounts are treated as wages and are subject to withholding and payment of employment taxes.

Retirement and pension plans

Employer contributions to a qualified retirement or pension plan are excluded from wages for purposes of withholding and employment taxes. Employer contributions to individual retirement accounts under a simplified employee pension plan ("SEP") are also excluded from wages, except for amounts that are contributed under a salary reduction agreement ("SAR-SEP"). An employer's nonelective or matching contributions are exempt from FICA. Distributions from qualified retirement and pension plans and section 403(b) annuities are also exempt from FICA.

Elective contributions to a 401(k) plan, however, are subject to FICA.[38]

Scholarship and fellowship payments

Amounts paid by an employer as part of a qualified scholarship to a candidate for a degree may be excluded from the recipient's wages. A qualified scholarship is any amount granted as a scholarship or fellowship that is used for tuition and fees required to enroll in, or to attend, an educational institution, or fees, books, supplies, and equipment that are required for courses at the educational institution.

The exclusion does not apply to the portion of any amount received that represents payment for teaching, research, or other services required as a condition of receiving the scholarship.[39]

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[37] There are special rules for certain highly compensated employees. See sec. 105(h).

[38] "Elective contributions" are employer contributions made to a plan pursuant to an election under a cash or deferred arrangement. See Treas. Reg. sec. 1.401(k)(6).

Sick pay

In general, sick pay is any amount paid by an employer to an employee who is unable to provide services due to sickness or injury. Sick pay is generally subject to FICA. There is, however, certain sick pay that is excluded from FICA, including: (1) payments made after an employee's death, disability, or retirement if the payments would not otherwise have been made; (2) payments made after the calendar year of the employee's death; (3) payments made to an employee entitled to disability insurance benefits; (4) payments made after the end of the sixth calendar month after the calendar month the employee last worked for the employer; (5) payments attributable to employee contributions.

Wages paid in kind

Wages paid in a medium other than cash or a readily negotiable instrument are said to be paid "in kind." Payments in kind may take the form of lodging, food, clothing, or other services. Generally, the fair market value of the in kind payments, determined at the time the payments are provided, are considered wages and are subject to FICA.

In an exception to the general rule, noncash payments for household work, agricultural labor, and services not in the employer's trade or business may be exempt from FICA.[40]

Other special rules

In addition to specific examples discussed above, there are special rules for various types of services and payments that may exclude such services and payments from FICA. These special rules encompass, among others, the following circumstances: (1) payments to general or limited partners of a partnership; (2) certain supplemental unemployment compensation plan benefits; (3) tips if the combined total is less than $20 in a month; (4) worker's compensation; (5) domestic service in private homes if payments of less than $1,700 were made during the calendar year or if performed by an individual under age 18 and whose principal occupation is not as a household employee; (6) certain income derived from Indian fishing rights; (7) remuneration received from the exercise of certain statutory stock options; and (8) certain outplacement services provided to employees to help them find new employment (e.g., career counseling, resume assistance, and skills assessment).

Definition of employment

For purposes of FICA, employment generally means any service performed by an employee for an employer if the service is either performed within the United States, performed in connection with an American vessel or aircraft, performed outside the United States by an

[39] Special rules apply to scholarships received through the National Health Services Corps Scholarship Program and the Armed Forces Health Professions Scholarship and Financial Assistance Program.

[40] Noncash payments for agricultural labor, such as commodity wages, are treated as cash payments subject to FICA if the substance of the transaction is a cash payment. See, IRS Publication 15 (Cat. No. 10000W).

American citizen or resident for an American employer, or is covered under an agreement governed by section 233 of the Social Security Act.[41]

Employment not subject to FICA

Certain types of employment are specifically excluded from FICA coverage.[42] Common exceptions are described below.

All services performed by an individual during a pay period for the same employer are treated alike, either entirely subject to FICA or entirely exempt.[43] If one-half or more of an individual's services in a particular pay period are subject to FICA, all services are subject to the tax for that period. If, however, less than half of the services are subject to FICA, then none of the individual's services are subject to the tax for that period.[44] A pay period is a period of not more than 31 consecutive days for which a payment of remuneration is ordinarily made to the employee by the employer.

Foreign agricultural employees

Services performed by certain foreign agricultural workers lawfully admitted to the United States for the purpose of performing agricultural labor on a temporary basis are not considered employment for purposes of FICA. Agricultural labor includes, among other services, cultivating the soil and raising livestock, and the operation, management, and maintenance of farm tools and equipment.[45]

Student employees

Services performed in the employ of a school, college, or university (or an auxiliary nonprofit organization operated and controlled by a school, college, or university) are exempt

[41] Section 233 of the Social Security Act, 42 U.S.C. sec. 433, authorizes the President to enter into a totalization agreement with a foreign country to coordinate the collection of payroll taxes and the payment of benefits under each country's social security system for individuals who divide their careers between multiple countries.

[42] Sec. 3161(b). Note, however, that exemption from FICA does not necessarily indicate exemption from SECA as well. We do not discuss exceptions from FICA covered employment that are no longer of practical import, such as, for example, certain exceptions for employees continuously employed by a non-profit organizations since 1984, and employees of certain communist organizations required to register with the Subversive Activities Control Board (which is defunct as of 1968). See, for example, sec. 2601(e)(1) of Public Law. No. 98-369 and Code sec. 3121(b)(17).

[43] Sec. 3121(c).

[44] Treas. Reg. sec. 31.3121(c)-1(d). This rule does not apply if the periods for which the employer compensates its employees vary to the extent that there is no "ordinary" pay period or if the pay period ordinarily exceeds 31 days. Treas. Reg. sec. 31.3121(c)-1(g). The rule also does not apply to service excluded because it is covered under the Railroad Retirement Tax Act or domestic services performed in the private home of an employer by an individual under the age of 18 whose principal occupation is not the performance of domestic services.

[45] Treas. Reg. sec. 31.3121(g).

from FICA if the service is performed by a student who is regularly attending classes at such educational institution.[46] The student FICA exception is based on the idea that the student's primary relationship with the educational institution is that of a student rather than that of an employee.[47]

Excepted student employment includes domestic services performed for a local college club or local chapter of a college fraternity or sorority by a student who is enrolled in and regularly attending classes at an educational institution. Student employees of Federal hospitals, other than medical and dental interns, are excepted from FICA, as are student nurses performing part-time services in a hospital for nominal earnings and as an incidental part of their training.

Government employees

Federal employees

Employees of the United States or any of its instrumentalities are generally subject to FICA for services performed after 1983. Certain service is excluded from coverage, however, if it was exempt prior to 1984.[48] Service prior to 1984 was generally exempt if it was covered by another retirement system established under Federal law or by a Federal instrumentality. Certain other Federal employees' service is also excluded, but only if the employee has been continually performing such service[49] since December 31, 1983 or is receiving an annuity under a retirement system established by the Federal government. Service performed by employees of the legislative branch may be exempt from FICA if the employee was subject to the Civil Services Retirement System, or certain other Federal retirement systems, on December 31, 1983.[50] All serving Members of Congress are covered by Social Security.

Services performed by inmates of a federal penitentiary, by student nurses and student employees (other than medical or dental interns or residents) for a Federal hospital, and by individuals serving on a temporary basis as a result of fire, storm, earthquake, or similar emergency, continue to be exempt from FICA.

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[46] Medical residents are not students for purposes of this exception, and thus stipends paid to medical residents after April 1, 2005 are subject to FICA. See, *Mayo Foundation v. U.S.* (S. Ct. No. 09-837, 2011). The IRS, however, has made an administrative determination to treat medical residents as students for purposes of FICA for periods ending before April 1, 2005 (the date Treasury Regulation 31.3121(b)(1)-2 became effective). See, IRS News Release IR-2010-25 (March 2, 2010).

[47] Treas. Reg. sec. 31.3121(b)(10)-2.

[48] Such service is generally, however, exempt only with respect to OASDI, and is still subject to the HI tax. Sec. 3121(u).

[49] Continuous service includes any period following a separation from service that is less than 366 consecutive days, and certain service during an individual's detail or transfer to an international organization or as a member of a uniformed service of the United States. See sec. 3121(b)(5).

[50] Sec. 3121(b)(5)(G)(i).

State and local government employees

Employees of State and local governments, or instrumentalities that are wholly owned by one or more State or political subdivision, (other than employees of the District of Columbia, Guam, and American Samoa) are generally subject to FICA for services performed after July 1, 1991. There is an exception for certain individuals who participate in a retirement program maintained by a State or local government, and whose benefits under that plan are comparable to the benefits they would have received under social security,[51] although such employees are still subject to the HI tax if their employment began (or restarted) after March 31, 1986.

Services performed by individuals who are employed by a State or local government (1) in order to relieve such individual from unemployment, (2) in a hospital or home as a patient or inmate, (3) on a temporary basis dues to a disaster, (4) as an election worker receiving less than $1,200 during the year, or (5) who are compensated on a fee basis, are not subject to FICA.

Subject to exceptions for certain elected officials and patients or inmates of hospitals and penitentiaries, services performed while in the employ of Guam or American Samoa (including their subdivisions and instrumentalities) are subject to FICA.

Service performed in the employ of the District of Columbia is generally subject to FICA unless it is covered by a retirement program established under Federal law.[52] Exceptions apply, however, for services performed: (1) in a hospital or penal institution by a patient or inmate, (2) by a student employee (other than a medical or dental resident or intern) in a D.C. hospital, (3) on a temporary basis as a result of a disaster, or (4) by a member of a board, committee, or council of the District paid on a per diem, meeting, or similar basis.[53]

Special rules apply to services performed in connection with the operation of public transit systems.[54]

Employees of foreign governments

Services performed by an employee of a foreign government (and, in some cases, foreign instrumentalities) are generally exempt from FICA, regardless of whether the foreign government grants similar exemptions with respect to services performed in the foreign country by a U.S. citizen.[55] This exception applies to ambassadors, ministers, diplomatic officers and employees, consular officers, and non-diplomatic representatives.

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[51] Treas. Reg. sec. 31.3121(b)(7)-2.

[52] Sec. 3121(b)(7)(C). Such service may be subject to the HI tax with respect to employees hired, or rehired, after March 31, 1986. See sec. 3121(u).

[53] *Ibid.*

[54] Sec. 3121(j).

[55] Sec. 3121(b)(11) and (12).

Employees of international organizations

Services performed by an individual employed by an international organization are generally exempt from FICA.[56] Special rules apply, however, to Federal employees who are temporarily transferred to an international organization after 1994.[57]

International organizations are public organizations entitled to the privileges, exemptions, and immunities available to international organizations under the International Organization Immunities Act. Examples of international organizations include the United Nations, the World Health Organization, and the World Bank.

Nonimmigrant aliens

Aliens admitted to the United States on certain student visas are exempt from FICA,[58] as are certain residents of the Philippines working in Guam.[59]

Family employees

Several exceptions to FICA exist for employees who are members of the same family as their employers. Service performed by a child less than 18 years of age in the employ of his or her parent is excluded from FICA. Service not in the regular course of the employer's trade or business or domestic service in a private home of the employer, performed by an individual under age 21 in the employ of his or her parent, or performed by an individual in the employ of his or her spouse or child, is also generally excepted from FICA.[60]

Religious service

Services performed by an ordained, commissioned, or licensed minister in the exercise of his or her ministry, or by a member of a religious order in performing duties required by the order, are generally exempt from FICA.[61] Churches and certain church-controlled organizations may elect to have services performed for them excluded from FICA if the employer is opposed to the payment of social security taxes due to religious reasons. Such election does not apply to services performed for the church or organization in an unrelated trade or business.

[56] Sec. 3121(b)(15).

[57] Sec. 3121(y).

[58] Sec. 3121(b)(9).

[59] Sec. 3121(b)(18).

[60] Sec. 3121(b)(3).

[61] Sec. 3121(b)(8).

Members of religious sects

Employees who are members of religious sects that are conscientiously opposed to the acceptance of public and private insurance benefits, for example, the Old Order Amish,[62] may apply for exemption from FICA, provided the employer has also applied for and received a similar exemption.[63]

Railroad employees

Service performed by an employee or employee representative whose compensation is subject to the Railroad Retirement Act[64] is exempt from FICA.[65]

Newspaper distributors

Delivering and distributing newspapers or shopping news (i.e., handbills and similar advertising material) is exempt from FICA if the employee performing the services is less than 18 years old and the material is distributed to the ultimate consumer.[66] The sale of newspapers and magazines is exempt from FICA, regardless of the seller's age, if the merchandise is sold at a fixed price and the seller's compensation is based on his or her keeping the excess of the fixed price charged to consumers over the amount that the seller paid for the merchandise.[67]

Fishing Crews

Services performed by an employee on a boat engaged in catching aquatic forms of animal life are exempt from FICA if: (1) the employee's remuneration must be entirely based on the amount of aquatic life caught, and (2) the operating crew of the boat (or each boat on which the individual works, if there are multiple vessels involved) is normally made up of less than ten people.[68] If the individual receives cash payments in addition to his or her share of the vessel's catch, the exemption does not apply unless the payment does not exceed $100 per trip, the payment is contingent on a minimum catch, and the payment is paid solely for additional duties (for example, as an engineer or cook) for which additional payment is customary.

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[62] See T.C. Memo 1990-32, 58 CCH TCM 1242.

[63] Sec. 3127.

[64] Secs. 3201 through 3233.

[65] Sec. 3121(b)(9).

[66] Sec. 3121(b)(14)(A).

[67] Sec. 3121(b)(14)(B). This exception applies only to sales to the ultimate consumer, thus, for example, sales to a regional distributor of a newspaper are not included in the rule.

[68] Sec. 3121(b)(20).

Real estate agents and direct sellers

Services performed by certain qualified real estate agents and direct sellers are exempt from FICA.[69] A "qualified real estate agent" is a licensed agent whose remuneration is substantially related to sales or other output (including appraisals) rather than the number of hours worked. The services of the agent must be performed in connection with a written contract between the agent and the person for whom the services are being performed specifying that the agent will not be treated as an employee. A "direct seller" includes any person engaged in the trade or business of selling, or soliciting the sale of, consumer products to the ultimate consumer or for resale to a buyer on a buy-sell basis, a deposit-commission basis, or any similar basis, provided the sale does not occur in a permanent retail establishment. As with real estate agents, substantially all of the remuneration received by the seller must be directly related to sales or other output rather than the number of hours worked, and the service must be performed pursuant to a written agreement stating that the seller is not an employee.

Elected coverage

Under certain circumstances employers may enter into an agreement with the Federal government to extend social security coverage to service that would otherwise be exempt from FICA. An American employer may enter into such an agreement with the IRS for certain services that are performed outside the United States by citizens or residents of the United States who are employees of a foreign affiliate of the American employer.[70] By entering into such an agreement the American employer becomes liable for the employee and employer portions of FICA, including amounts equivalent to interest, additions to taxes, and applicable penalties, as if the employee's services were otherwise subject to FICA. The employer is under no obligation, however, to deduct, or cause to be deducted, from the employee's pay any part of the amount due from the employer.

In addition to employees of foreign affiliates, most exempt employees of State and local governments are brought into the social security system through voluntary coverage agreements between their employer and the Commissioner of Social Security.[71] All 50 States, Puerto Rico, and the U.S. Virgin Islands are eligible to enter into coverage agreements. The District of Columbia, Guam, and American Samoa, however, may not enter into such agreements.[72] Each governmental employer divides its employees into coverage groups and then decides which groups will be covered under the agreements.[73] Under certain circumstances, employees must

[69] Sec. 3508(a). They are, however, subject to SECA. Rev. Rul. 85-63.

[70] Sec. 3121(l). No agreement under 3121(l) may be terminated on or after June 15, 1989.

[71] 42 U.S.C. sec. 418(a)(1).

[72] 42 U.S.C. sec. 418(c)(1).

[73] It is worth noting that not all types of employees may be included in a coverage group, e.g., employees who are hired solely to provide relief from unemployment, services performed in a hospital, home, or other institution by a patient or inmate. See 42 U.S.C. sec. 418(c)(6).

also vote to be covered in order for the agreement to take effect.[74] After April 19, 1983, agreements extending social security coverage to State and local employees cannot be terminated either by the employer or the Social Security Administration.[75]

A religious order whose members are required to take a vow of poverty (or an autonomous subdivision of such order) may elect to have social security coverage extended to service performed by its members in the exercise of duties required by such order.[76] Such an election must specify that (1) it is irrevocable, (2) it applies to all current and future members, (3) all services performed in the exercise of the member's required duties are deemed to have been performed as an employee of the order, and (4) the order will pay the employer and employee portion of FICA with respect to the wages of each active member, including the fair market value (but not less than $100 per month) of any board, lodging, clothing, and other perquisites furnished to a member by the order.

[74] 42 U.S.C. sec. 418(d)(6).

[75] 42 U.S.C. sec. 418(g).

[76] Sec. 3121(b)(8)(A) and (r)(1).

B. Self-Employment Contributions Act

In general

Generally, tax under SECA is imposed on the self-employment income of an individual. SECA tax has two components. Under the OASDI tax component, the rate of tax is 12.40[77] percent on self-employment income up to the Social Security wage base ($106,800 for 2011).[78] Under the HI tax component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base).[79]

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. An individual may use one of three methods to calculate net earnings from self-employment.[80] Under the generally applicable rule, net earnings from self-employment means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. Alternatively, an individual may elect to use one of two optional methods for calculating net earnings from self-employment. These methods are: (1) the farm optional method; and (2) the nonfarm optional method. The farm optional method allows individuals to pay SECA taxes (and secure Social Security benefit coverage) when they have low net income or losses from farming. The nonfarm optional method is similar to the farm optional method.

Additional HI for self-employed individuals

For remuneration received in taxable years beginning after December 31, 2012, an HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount. [81]

The threshold amount for the additional SECA HI tax is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction is allowed under section 164(f) for the additional SECA tax, and the deduction

[77] A special rule for 2011 temporarily reduces the SECA for OASDI from 12.4 percent to 10.4 percent. See section 601 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312. This reduction is not taken into account for purposes of the deduction under section 1402(a)(12).

[78] Sec.1401(a). In calculating the SECA tax for OASDI, the Social Security wage base taken into account is reduced by FICA wages paid to the individual during the taxable year.

[79] Sec. 1401(b)(1).

[80] Sec. 1402(a).

[81] Sec. 1401(b)(2).

under 1402(a)(12) (generally for one-half of the sums of the rates for OASDI and HI) is determined without regard to the additional SECA tax rate.

Net earnings from self employment

General rule

Net earnings from self-employment is the gross income derived by an individual from any trade or business less allowed deductions which are attributable to the trade or business and allowed under the SECA rules. Certain passive income and related deductions are not taken into account in determining net earnings from self employment, including rentals from real estate unless received in the course of income as a real estate dealer,[82] dividends and interest unless such dividend and interest are received in the course of a trade or business as a dealer in stocks or securities,[83] and sales or exchange of capital assets and certain other property unless the property is stock in trade which would properly be included in inventory or held primarily for sale to customers in the ordinary course of the trade or business.[84]

For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's net self employment income (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings.[85] This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes. This is generally referred as the "regular method" of determining net earnings from self employment, and in forms and publications is expressed as multiplying total self employment net income by 92.35 percent.

Treatment of Conservation Reserve Program payments

The Conservation Reserve program ("CRP")[86] is a voluntary program under which the United States Department of Agriculture ("USDA") through the Commodities Credit Corporation makes annual payments to participants. Participants include farm owners and operators who agree to place environmentally sensitive cropland in conserving uses for 10 to 15 years. Participants receive an annual "rental" payment (including incentive payments) and cost sharing assistance to establish and maintain approved groundcover, and participants agree to plant grasses, trees, and other conserving cover crops, restore wetlands and establish buffers.

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[82] Sec. 1402(a)(1).

[83] Sec. 1402(a)(2).

[84] Sec. 1402(a)(3).

[85] Sec. 1402(a)(12). For the purpose of determining this deduction in 2011, the two percentage point reduction in the SECA tax rate is disregarded.

[86] 16 U.S.C. secs. 3801, 3831-3836.

Generally, a participant is eligible to enroll land in CRP if the participant has owned or operated the land for at least twelve months prior to the close of the CRP sign up period. Land is eligible for placement in CRP if it is cropland or marginal pasture land. Generally, CRP rental payments are self employment income.[87] However, in the case of individuals receiving Social Security retirement or disability benefits, CRP payments are excluded from self employment income for purposes of SECA taxes.[88]

Optional methods of determining self employment income

Farm optional method

If an individual is engaged in a farming trade or business, either as a sole proprietor or as a partner, the individual may elect to use the farm optional method in one of two situations. The first situation is an individual engaged in a farming business who has gross farm income of not greater than 150 percent of a specified dollar amount (the specified dollar amount is $4,480 for 2011).[89] In this situation, the individual may elect to report two-thirds of gross farm income as net earnings from self-employment. In the second situation, an individual engaged in a farming business may elect the farm optional method even though gross farm income exceeds this limit (150 percent of $4,480, or $6,720 for 2011) but only if the net farm income is less than $4,851 for 2011.[90] In this second instance, the individual may elect to report the dollar amount ($4,480 for 2011) as net earnings from self-employment for the taxable year and be entitled to four quarters of coverage for the year. In all other situations (i.e., more than $6,720 of gross farm income for 2011 and net farm income of at least $4,851 for 2011) a person engaged in a farming business must compute net earnings from self-employment under the generally applicable rule. There is no limit on the number of years that an individual may elect the farm optional method during such individual's lifetime.

Nonfarm optional method

The nonfarm optional method is available only to individuals who have been self-employed for at least two of the three years before the year in which they seek to elect the nonfarm optional method and who meet certain other requirements. Specifically, an individual may elect the nonfarm optional method if the individual's: (1) net nonfarm income for the taxable year is less than $4,851; and (2) net nonfarm income for the taxable year is less than 72.189 percent of gross nonfarm income. If a qualified individual engaged in a nonfarming business that elects the nonfarm optional method has gross nonfarm income of $6,720 (for 2011) or less for the taxable year, then the individual may elect to report two-thirds of gross nonfarm

[87] *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000).

[88] Sec. 1401(a)(1)

[89] The specified dollar amount is the amount of wages or self-employment income required under section 213(d) of the Social Security Act to earn four quarters for the year ($4,480 for 2011)

[90] Net income for this purpose is determined before the deduction of 7.65 percent of net earnings allowed under section 1402(a)(12) (generally for one-half of the sums of the rates for OASDI and HI) .

income as net earnings from self-employment. If the electing individual engaged in a nonfarming business has gross nonfarm income of at least $4,851 for 2011, then the individual may elect to report $4,480 as net earnings from self-employment for the taxable year. In all other instances, a person engaged in a nonfarming business must compute net earnings from self-employment under the generally applicable rule. An individual may elect to use the nonfarm optional method for no more than five years in the course of the individual's lifetime

SECA for employee ministers

If an individual is a minister of a church, the individual's earnings for the services performed as a minister are subject to SECA tax, even if the individual performs these services as an employee of a church. Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances or sacraments according to the prescribed tenets and practices of a church or denomination. If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a minister for Social Security purposes.

In calculating net earnings from self-employment, a minister generally includes the following in gross income: salaries and fees for ministerial services, offerings received for marriages, baptisms, funerals, masses, etc., the value of meals and lodging provided to the minister, and the minister's spouse, and dependents for the minister's employer's convenience, and the fair rental value of a parsonage provided to the minister (including the cost of utilities that are furnished) and the rental allowance (including an amount for payment of utilities) paid to the minister.

C. Unearned Income Medicare Contribution

Medicare contribution tax on unearned income

For taxable years beginning after December 31, 2012, a new Code provision, section 1411, enacted as part of the Health Care and Education Reconciliation Act of 2010,[91] provides a Medicare contribution tax on unearned income. The tax is applicable to an individual, estate, or trust. No provision is made for the transfer of the tax from the General Fund of the United States Treasury to any Trust Fund.

In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

Net investment income

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the ordinary course of any trade or business to which the tax does not apply), (2) other gross income derived from any trade or business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.[92] Investment income does not include distributions from a qualified retirement plan or amounts subject to SECA tax.

[91] Pub. L. No. 111-152, sec. 1402.

[92] Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax.

Application to trade or business income

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses. Income, gain, or loss on working capital is not treated as derived from a trade or business.

Application to disposition of partnership and S corporation stock

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.[93]

[93] For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

III. SPECIAL CASES

A. Worker Classification for Employment Tax Liability

In general

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test under common law that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed.[94] However, under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though, applying the common-law test, the facts and circumstances indicate that the worker is properly classified as an employee. This safe harbor applies if the service recipient has a reasonable basis for treating the worker as an independent contractor (including certain specified safe harbors) and certain other requirements are met. In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into specific provisions of the Code or that is required to be used pursuant to Treasury regulations or case law. For example, section 3121(d)(2) (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) generally defines the term "employee" to include any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. By contrast, section 3401 (which defines terms for purposes of an employer's Federal income tax withholding obligation with respect to wages paid to an employee) does not define the term "employee." However, regulations issued under section 3401 incorporate the common-law test.

The regulations under section 3401 provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[95] Under the regulations, it is not necessary that the employer actually exercises control over the manner in which the services are performed, rather, it is sufficient that the employer has

[94] Generally the determination of whether a worker is an employee or independent contractor is referred to as worker classification. Because a service recipient is required to withhold income tax and FICA from an employee's wages, and is liable for payment of the employer portion of FICA, during a calendar year, and thus generally must take a position as to the worker's classification before the worker files an income tax return, the first classification of a worker is generally made by the service recipient.

[95] Treas. Reg. sec. 31.3401(c)-(1)(b).

a right to such control.[96] Whether the requisite control exists is determined based on all the relevant facts and circumstances.[97] Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether an employer-employee relationship exists.

The origin of the common-law test is the master and servant employment relationship as described in the Restatement (Second) of Agency. Under the Restatement, classification of a worker as a servant (that is, employee) rather than an independent contractor is based on a facts and circumstances determination. The facts are generally evaluated to determine the extent of the service recipient control. The principal difference between a servant and an independent contractor is the extent of control. In the case of a servant, by agreement, the master may exercise control over the details of the work, both with respect to the result the worker is to accomplish and the means by which such result is accomplished.[98] Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether a master-servant (that is, employer-employee) relationship exists.

In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[99] The degree of importance of each factor varies depending on the occupation and the

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[96] *Ibid.* See also, *Gierek v. Commissioner*, 66 T.C.M. 1866 (1993) (involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised). See also, Internal Revenue Service Publication 1779: Independent Contractor or Employee (Rev. 1-2005).

[97] Restatement of Agency 2nd , sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, page A-9.

[98] Restatement of Agency 2nd, sec. 220 (1958), *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, and Alden J. Bianchi, "Employee Benefits for the Contingent Workforce," Tax Management Portfolio 399, p. A-9.

[99] Rev. Rul. 87-41, 1987-1 C.B. 296 (providing guidance with respect to section 530 of the Revenue Act of 1978). The 20 factors identified by the IRS are: (1) instructions (compliance with instructions required indicates employee status); (2) training (the provision of training by service recipient indicates employee status): (3) integration (integration of the worker's services into the business operations of service recipient indicates employee status); (4) services must be rendered personally (indication of employee status); (5) hiring, supervision, and paying assistants (if service recipient hires, supervises or pays assistants, it indicates employee status, but if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status); (6) continuing relationship (indicates employee status); (7) set hours of work (indicates employee status); (8) full time services required (indicates employee status); (9) work done on employer's premises (indicates employee status if work could be done elsewhere); (10) order or sequence test (indicates employee status if a worker must perform services in the order or sequence set by service recipient); (11) oral or written reports required (indicates employee status); (12) payment by the hour, week, or month (indicates employee status); (13) payment of business and/or traveling expenses (indicates employee status): (14) furnishing tools and materials by service recipient (indicates employee status); (15) significant investment by worker (indicates independent contractor status); (16) realization of profit or loss by worker (indicates independent contractor status); (17) working for more than one firm at a time (indicates independent contractor status); (18) making services available to the general public (indicates independent

factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[100] The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.[101]

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 ("section 530") generally allows a taxpayer who is a service recipient to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment or otherwise fails to meet certain requirements.[102] Section 530 only applies to the service recipient and only applies for purposes of employment taxes. Under section 530, a reasonable basis for treating a worker as an independent contractor is deemed to exist if the taxpayer reasonably relied on: (1) past IRS audit practice with respect to the taxpayer, (2) published rulings, technical advice with respect to the taxpayer, or judicial precedent, or (3) long-standing recognized practice of a significant segment of the industry in which the taxpayer is a member. With respect to the industry practices safe harbor, section 530 specifically provides that the significant segment requirement does not require practice by more than 25 percent of the industry (determined without taking the taxpayer into account). The "long-standing" requirement does not require the practice to have continued for more than 10 years and the practice does not fail to be long standing merely because it began after 1978. In addition, a taxpayer can rely on any "other reasonable basis" for treating a worker as an independent contractor.

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The taxpayer must not have treated the worker as an

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contractor status); (19) service recipient has right to discharge (indicates employee status); (20) worker has right to terminate relationship (indicates employee status).

[100] Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I, pp. 2-7. This document is publicly available through the IRS website.

[101] *Ibid.* p. 2-3 through p. 2-7.

[102] The relief provided to an employer under section 530 was initially a temporary measure (scheduled to terminate at the end of 1979) to give Congress time to resolve the many complex issues regarding worker classification. Section 530 was permanently extended in 1982 and later revised. Section 530 was extended through the end of 1980 by Pub. L. No. 96-167 and through June 30, 1982, by Pub. L. No. 96-541. It was permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982. A number of changes to section 530 were made by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006.

employee for any period, and for periods after 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position to the worker as an employee for purposes of employment taxes for any period beginning after 1977 (the "similar worker consistency requirement").[103]

Section 530 does not apply in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[104] Thus, the determination of whether such workers are employees or independent contractors for purposes of employment taxes is made in accordance with the common-law test.

Section 530 also prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.[105] However, in response to a taxpayer request, the IRS may issue a written determination regarding the status of a particular worker as an employee or independent contractor for purposes of Federal employment taxes and income tax withholding.[106]

Statutory employees or independent contractors

The Code contains various provisions that prescribe treatment of a specific category or type of worker as an employee or an independent contractor. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[107] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for Social Security tax

[103] Under section 864 of the Pension Protection Act of 2006 (Pub. L. No.109-280, the similar worker consistency requirement does not apply with respect to services performed after December 31, 2006, by an individual who provides services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations. This exception only applies if the service recipient is an organization that is described in section 501(c) and the service provider is not otherwise treated as an employee of the organization for employment tax purposes

[104] Section 1706 of the Tax Reform Act of 1986.

[105] Rev. Rul. 87-41 (described above) provides guidance with respect to section 530 of the Revenue Act of 1978.

[106] IRS Form SS-8 (Rev. 11-2006). A written determination with regard to prior employment status may be issued by the IRS. The IRS will not issue a written determination with respect to prospective employment status. Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

[107] Sec. 3508.

and employee benefit purposes,[108] and certain salesmen are treated as employees for Social Security tax purposes.[109]

[108] Sec. 3121(d)(3)(B) and 7701(a)(20).

[109] Sec. 3121(d)(3)(D).

B. Employment Tax and Self-Employment Tax Treatment of S Corporation Shareholders and Partners

S corporation shareholders

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[110]

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation.

A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income. Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. Case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[111]

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[112] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[113] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was

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[110] Sec. 1366.

[111] See the discussion of case law in, e.g., Richard Winchester, *The Gap in the Employment Tax Gap,* 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[112] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[113] See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

compensated.[114] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[115]

Partners

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, gain and loss.[116]

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes.

A partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[117]). This general rule applies to partners who are individuals and who are not limited partners to whom the exception (described below) applies. Thus, this general rule applies to individuals who are general partners.

An exclusion from SECA applies for limited partners of a partnership.[118] Specifically, in determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[119]

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[114] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[115] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

[116] Secs. 701, 702.

[117] Sec. 1402(a).

[118] Sec. 1402(a)(13).

[119] In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for Federal tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.[120] The rule imposing SECA tax on individuals who are partners in a partnership, and the exclusion from SECA for limited partners, have not been modified to address the treatment of limited liability company members who are treated as partners for Federal tax purposes.

[120] In *Renkemeyer, Campbell & Weaver, LLP, v. Commissioner*, 136 T.C. 7 (February 9, 2011), the Tax Court held that partners in a law firm that is a limited liability partnership (LLP) (not a limited liability company) under applicable State law are subject to self-employment tax. Thus, the exception for limited partners under section 1402(a)(13) did not apply in *Renkemeyer*. The Tax Court noted that "[i]n essence, an L.L.P. is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities," and concluded after a review of the legislative history of section 1402(a)(13), "[t]he insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage." 136 T.C. 7, pages 7 and 9.

IV. INCOME TAXATION OF SOCIAL SECURITY BENEFITS

Under present law, Social Security benefits are taxed under a two-tier system. Taxpayers receiving Social Security benefits are not required to include any portion of such benefits in gross income if their provisional income does not exceed a first-tier threshold, which is $25,000, in the case of unmarried individuals, or $32,000, in the case of married individuals filing jointly.[121] For purposes of these computations, a taxpayer's provisional income is defined as adjusted gross income plus: (1) tax-exempt interest; (2) excludable interest on educational savings bonds; (3) adoption assistance payments; (4) certain deductible student loan interest; (5) certain excludable foreign-source earned income; (6) certain U.S. possession income; and (7) one-half of the taxpayer's Social Security benefits. A second-tier threshold for provisional income is $34,000, in the case of unmarried individuals, or $44,000, in the case of married individuals filing joint returns.[122] The thresholds are not indexed for inflation.

If the taxpayer's provisional income exceeds the first-tier threshold but does not exceed the second-tier threshold, then the amount required to be included in income is the lesser of (1) 50 percent of the taxpayer's Social Security benefits, or (2) 50 percent of the excess of the taxpayer's provisional income over the first-tier threshold.

If the amount of provisional income exceeds the second-tier threshold, then the amount required to be included in income is the lesser of: (1) 85 percent of the taxpayer's Social Security benefits; or (2) the sum of (a) 85 percent of the excess of the taxpayer's provisional income over the second-tier threshold, plus (b) the smaller of (i) the amount of benefits that would have been included in income if the 50 percent inclusion rule (described in the previous paragraph) were applied, or (ii) one-half of the difference between the taxpayer's second-tier threshold and first-tier threshold.[123]

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[121] In the case of a married individual who files a separate return, the first-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the first-tier threshold is $25,000.

[122] In the case of a married individual who files a separate return, the second-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the second-tier threshold is $34,000.

[123] Special rules apply in some cases under present law. Tier I Railroad Retirement benefits are similar to Social Security benefits and are taxed in the same manner as Social Security benefits. In the case of nonresident individuals who are not U.S. citizens, 85 percent of Social Security benefits are includible in gross income and subject to the 30-percent withholding tax (sec. 871(a)(3)). The taxation of Social Security benefits may also be specified in income tax treaties between the United States and other countries.

<table>
<tr><th colspan="4">Summary of the Phase-out of Social Security Benefits for Unmarried Taxpayers</th></tr>
<tr><td>Provisional income level</td><td colspan="3">Amount included in taxable income</td></tr>
<tr><td>$24,999 and below[124]</td><td colspan="3">0%</td></tr>
<tr><td rowspan="2">$25,000 to $33,999[125]</td><td colspan="3">First-tier inclusion is the lesser of…</td></tr>
<tr><td>(1) 50% of Social Security benefit</td><td colspan="2">(2) 50% of provisional income exceeding $25,000[126]</td></tr>
<tr><td rowspan="3">$34,000 and above[127]</td><td colspan="3">Second-tier inclusion is the lesser of…</td></tr>
<tr><td rowspan="2">(1) 85% of Social Security benefit</td><td colspan="2">(2) 85% of the amount of provisional income exceeding $34,000[128] plus the lesser of…</td></tr>
<tr><td>(2a) $4,500[129]</td><td>(2b) amount of Social Security benefit that would have been included if the 50% rule applied</td></tr>
</table>

Revenues from the first-tier inclusion of Social Security benefits are dedicated to the Social Security Trust Funds (i.e., the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund). Revenues from the second-tier inclusion are dedicated to the Medicare Trust Funds (i.e., the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund).

[124] $31,999 and below for taxpayers who are married filing jointly.

[125] $32,000 to $43,999 for taxpayers who are married filing jointly.

[126] $32,000 for taxpayers who are married filing jointly.

[127] $44,000 and above for taxpayers who are married filing jointly.

[128] $44,000 for taxpayers who are married filing jointly.

[129] $6,000 for taxpayers who are married filing jointly.

APPENDIX
Social Insurance Taxable Wage Base and Rates of Tax

Year	Maximum Taxable Earnings	Contribution Rate for Both Employers and Employees (Percent of Covered Earnings)			Contribution Rate for Self-Employed Persons		
		Total	OASDI	HI	Total	OASDI	HI
1975	$14,100	5.85	4.95	0.9	7.9	7.0	0.9
1976	$15,300	5.85	4.95	0.9	7.9	7.0	0.9
1977	$16,500	5.85	4.95	0.9	7.9	7.0	0.9
1978	$17,700	6.05	5.05	1.00	8.1	7.1	1.0
1979	$22,900	6.13	5.08	1.05	8.1	7.05	1.05
1980	$25,900	6.13	5.08	1.05	8.1	7.05	1.05
1981	$29,700	6.65	5.35	1.3	9.3	8.0	1.3
1982	$32,400	6.7	5.4	1.3	9.35	8.05	1.3
1983	$35,700	6.7	5.4	1.3	9.35	8.05	1.3
1984[1]	$37,800	7.0	5.7	1.3	14.00	11.4	2.6
1985	$39,600	7.05	5.7	1.35	14.10	11.4	2.7
1986	$42,000	7.15	5.7	1.45	14.30	11.4	2.9
1987	$43,800	7.15	5.7	1.45	14.30	11.4	2.9
1988	$45,000	7.51	6.06	1.45	15.02	12.12	2.9
1989	$48,000	7.51	6.06	1.45	15.02	12.12	2.9
1990	$51,300	7.65	6.2	1.45	15.3	12.4	2.9
1991[3]	$53,400	7.65	6.2	1.45	15.3	12.4	2.9
1992	$55,500	7.65	6.2	1.45	15.3	12.4	2.9
1993	$57,600	7.65	6.2	1.45	15.3	12.4	2.9
1994	$60,600	7.65	6.2	1.45	15.3	12.4	2.9
1995	$61,200	7.65	6.2	1.45	15.3	12.4	2.9
1996	$62,700	7.65	6.2	1.45	15.3	12.4	2.9
1997	$65,400	7.65	6.2	1.45	15.3	12.4	2.9
1998	$68,400	7.65	6.2	1.45	15.3	12.4	2.9
1999	$72,600	7.65	6.2	1.45	15.3	12.4	2.9
2000	$76,200	7.65	6.2	1.45	15.3	12.4	2.9
2001	$80,400	7.65	6.2	1.45	15.3	12.4	2.9
2002	$84,900	7.65	6.2	1.45	15.3	12.4	2.9
2003	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2004	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2005	$90,000	7.65	6.2	1.45	15.3	12.4	2.9
2006	$94,200	7.65	6.2	1.45	15.3	12.4	2.9
2007	$97,500	7.65	6.2	1.45	15.3	12.4	2.9
2008	$102,000	7.65	6.2	1.45	15.3	12.4	2.9
2009	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2010	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2011	$106,800	[2]	[2]	1.45	13.3	10.4	2.9

[1] For 1984 only, employees were allowed a credit of 0.3 percent of taxable wages against their FICA tax liability, reducing the effective rate to 6.7 percent.

[2] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the FICA tax rate for employees by two percentage points for 2011. Specifically, the employer OASDI rate remains at 6.2 while the employee rate is reduced to 4.2.

[3] The maximum taxable earnings for HI purposes was raised beginning in 1991. The maximum taxable earnings for HI was $125,000 in 1991, $130,000 in 1992, $135,000 in 1993, and unlimited since 1994.