Costly Error in Payroll Tax Computation for the Self-Employed

By James Nunns

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In this article, Nunns explains the correct formulas to make the payroll taxes of the self-employed match those paid by workers earning comparable wages, and he considers the effects of applying those formulas.

Perhaps one sign of America's lagging status in math education is that lawmakers have never been able to make the payroll taxes for the self-employed match those paid by workers earning comparable wages. The law flubs some simple formulas, resulting in the self-employed paying less payroll taxes than other workers with the same earnings. The error totals half a billion dollars per year in tax savings for the self-employed, going disproportionately to those with very high incomes. Congress has missed many chances to repair the error, but a provision in the tax reform proposal recently introduced by House Ways and Means Committee Chair Dave Camp, R-Mich., would correct the formulas and bring in much-needed revenue. If legislators enacted that provision, the $5 billion gain in revenue over 10 years could offset part of the cost of extending expiring tax provisions or pay for intentional, better targeted tax cuts. And it would eliminate a glaring inequity in the code.

This article explains the correct formulas and the effects of applying them.

Payroll Taxes on Workers

Employers and employees remit payroll taxes to fund Social Security retirement and disability benefits (Old Age, Survivors, and Disability Insurance) and Medicare hospital insurance benefits (HI) under FICA. The 6.2 percent OASDI rate applies to both employers and employees on the first $117,000 of wages.[1] The 1.45 percent HI rate applies to both employers and employees on all wages. Employees pay an additional 0.9 percent Medicare rate on wages exceeding $200,000 ($250,000 of combined wages for married couples filing jointly).[2]

Sole proprietors and partners in partnerships are covered under a parallel system. They pay both the employer and employee portion of payroll taxes on their earnings under the Self-Employment Contributions Act (SECA). However, errors in the formulas for computing SECA reduce the payroll tax paid by the self-employed below the level paid on comparable wages.

The Correct Formulas

The tax base for FICA is the wage paid to an employee. On $100 of wages subject to both the OASDI and HI rates, the employer and employee each pay $7.65 (7.65 percent), for a total payroll tax of $15.30 (15.3 percent). The employer's total compensation cost is the $100 in wages plus the $7.65 of employer FICA, or $107.65. For $100 of wages paid above the $117,000 OASDI wage cap, an employer's total compensation cost drops to $101.45 because those wages are subject only to the 1.45 percent HI rate.[3]

To make the payroll tax under SECA equivalent to FICA, self-employment earnings should be reduced to account for the exclusion of the employer share of FICA from wages. For earnings subject to both OASDI and HI, $107.65 of self-employment earnings should be reduced to $100, which requires a deduction of $7.65 divided by $107.65, or 7.1064 percent. For earnings subject only to HI, $101.45 of self-employment earnings should be reduced to $100, which requires a deduction of $1.45 divided by $101.45, or 1.4293 percent.

[1]That is the amount in 2014.

[2]The threshold is $125,000 for married taxpayers who file separately.

[3]For high-earning employees with multiple jobs, employers may pay OASDI tax on aggregate earnings that exceed the $117,000 cap. For example, if a worker earned $100,000 from each of two jobs, each employer would remit $6,200 in OASDI taxes plus another $1,450 in HI tax. If the employee had earned the same total wages of $200,000 from a single job, her employer would remit only $7,254 in OASDI tax, or 6.2 percent of $117,000. So the two employers would pay a combined excess of $5,146 ($12,400 less $7,254) of OASDI that would not be refunded to the employers (or the employee). The employee would have a combined excess of $5,146 of employee OASDI withheld from her wages, but the overpayment would be refunded on her income tax return.

Further, the OASDI wage cap should be converted to an equivalent cap on self-employment earnings. The OASDI wage cap excludes 7.65 percent of employer payroll tax, so the equivalent amount of self-employment earnings must be increased by 7.65 percent. Multiplying the OASDI wage cap by 1.0765 therefore converts it to the equivalent cap on self-employment earnings.

Errors in the SECA Formulas

The SECA formulas contain three errors:

1. The applicable formula provides a deduction that is too large for wages below the OASDI wage cap. It calls for a deduction of 7.65 percent, an amount that is larger than the correct 7.1064 percent.[4] For example, instead of deducting 7.1064 percent multiplied by $107.65, or $7.65 from $107.65 of self-employment income to make the SECA base the equivalent of the FICA wage base of $100, the applicable formula calls for deducting 7.65 percent multiplied by $107.65, or $8.24, making the SECA base only $99.41.

2. The applicable formula provides the same 7.65 percent deduction for self-employment income subject only to HI rates, more than five times the correct deduction of 1.4293 percent. Instead of converting $101.45 of self-employment income above the OASDI cap into $100 of wages by allowing a deduction of $1.45 (1.4293 percent multiplied by $101.45), it allows a deduction of $7.76 (7.65 percent multiplied by $101.45), which makes the SECA base only $93.69. That large understatement applies only to workers with self-employment earnings above the OASDI cap.

3. The applicable formula converts the OASDI wage cap by multiplying it by 1.08284 instead of by the correct 1.0765 factor.[5] It makes the cap $126,692, which is higher than the correct cap of $125,951.

Examples

Two examples illustrate how the errors in the SECA formulas reduce the payroll taxes paid by the self-employed below the level paid by employees with comparable wages:

- *Worker with $100,000 of wages.* For an employee, the employer and employee shares of FICA are both 7.65 percent of wages, or $7,650, for a total payroll tax of $15,300. If the worker is self-employed, comparable earnings would be $107,650 — $100,000 plus the employer share of payroll taxes. Applying the 7.65 percent SECA deduction reduces the taxable earnings to $99,415. The SECA tax is then 15.3 percent of $99,415, or $15,210, $90 less than the tax on an employee with equivalent earnings. The savings are small — just 0.6 percent — but the cut increases in both absolute and relative terms as self-employment income grows.
- *Worker with $300,000 of wages.* For an employee, the employer and employee shares of FICA are both 7.65 percent of the first $117,000 of wages ($8,950.50) plus 1.45 percent of wages above that level ($2,653.50). The employee also pays the 0.9 percent additional Medicare tax on wages above $200,000 (assuming the worker is single), or an additional $900. The total tax would be $24,108 — $11,604 for the employer share plus $12,504 for the employee share. If the worker were self-employed, comparable earnings, including the employer share of payroll tax, would be $311,604, on which SECA tax should be $24,108.[6] The current deduction of 7.65 percent applies to all self-employment earnings, making the total SECA base $287,766. The employer and employee equivalent shares are $8,950.50 on the first $117,000 of that base plus 1.45 percent of the remainder (1.45 percent multiplied by ($287,766 less $117,000), or $2,476.11). The additional Medicare tax applies to the excess of that base above $200,000: 0.9 percent x ($287,766 less $200,000), or $789.90 — more than $100 less than for the employee. The total payroll tax would thus be $23,643.12, about $465 less than the employee would pay. The 1.9 percent savings in payroll taxes is more than three times that for the self-employed worker in the preceding example.

The payroll tax savings from the erroneous SECA formulas in the law generally increases with self-employment earnings up to about $126,000, when the too-high OASDI earnings cap reduces the tax savings (see figure).[7] Tax savings spike upward at

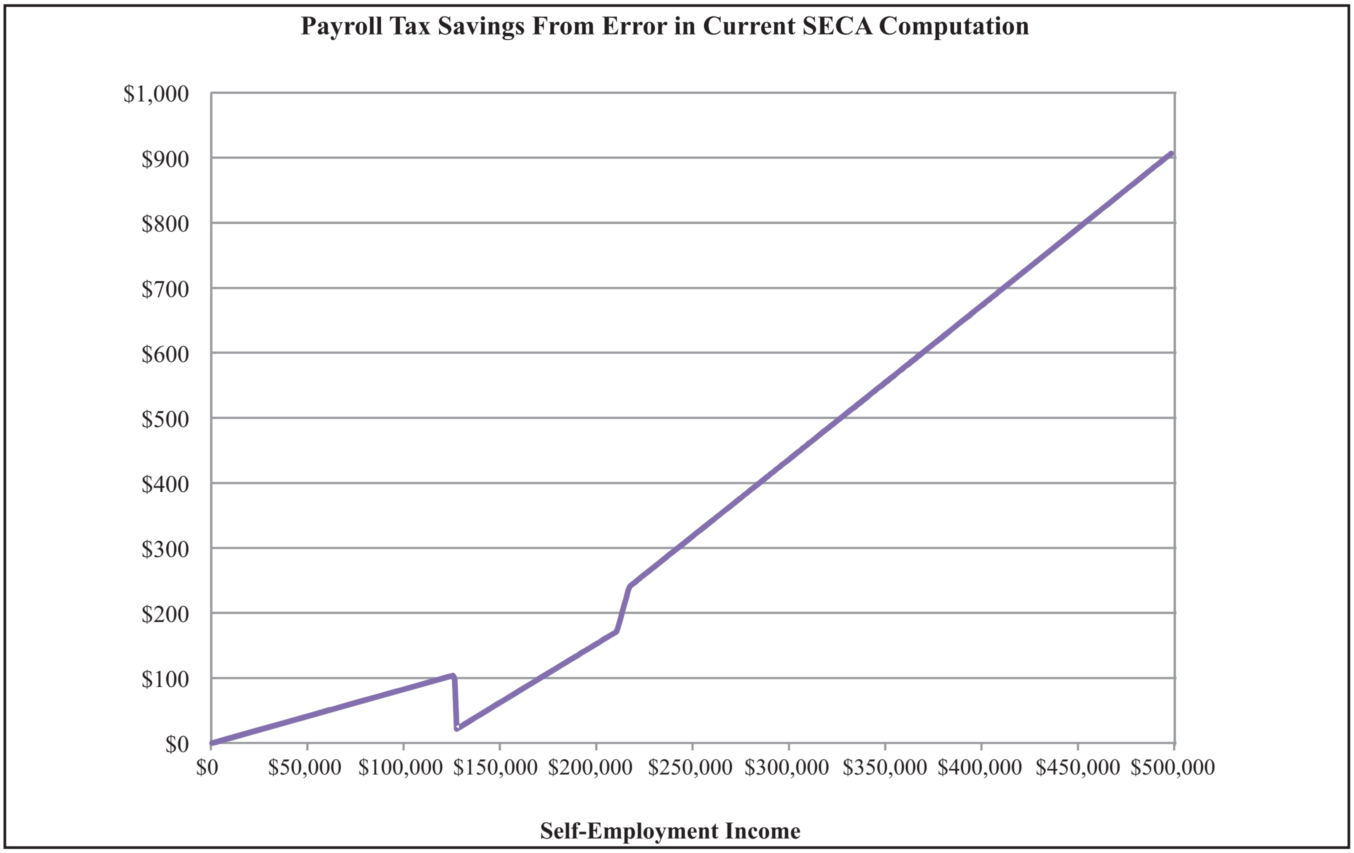
[4]Schedule SE of Form 1040, on which SECA payroll taxes (except the 0.9 percent surtax on high earners) are computed, reduces self-employment income by multiplying it by 92.35 percent (100 percent less 7.65 percent), instead of calling for taxpayers to compute the deduction and then subtract it.

[5]The SECA formulas allow a deduction of 7.65 percent at all levels of self-employment income, which converts the OASDI wage cap by a factor of 1 divided by (1 less 0.0765), or 1.08284.

[6]Statutorily, the 0.9 percent additional Medicare tax is part of both FICA and SECA, and employers are required to withhold it on wages above $200,000 (for all employees). Administratively, the additional Medicare tax is computed (and withholding of it on employees is reconciled) on Form 8959 for both employees and the self-employed.

[7]For self-employment earnings between the correct OASDI cap of $125,591 and the cap of $126,692, the deduction should be

(Footnote continued on next page.)



about $210,000 of earnings when imposition of the 0.9 percent additional Medicare tax is delayed by the current excessive deduction[8] and the higher tax rate raises the rate at which savings increase. By $500,000 the error is $910, at $1 million it is nearly $2,100, and at $10 million it is $23,367 (6 percent of the comparable FICA amount).

Income Tax Offset

The income tax base for wages paid to employees excludes the employer share of FICA. Thus, for income tax equivalence with employees, the self-employed are allowed an income tax deduction for the equivalent of the employer share of SECA. That deduction is for half of SECA liability (excluding the additional Medicare tax), and is available to all self-employed individuals because it is allowed above the line in computing adjusted gross income. Because SECA liability is too low at all levels of self-employment income, the income tax deduction is also too low, making AGI too high. As a result, the payroll tax savings for the self-employed is partially offset by higher income tax liabilities.[9] To illustrate, a self-employed individual with $107,650 of earnings would have an income tax deduction that is $45 lower than it should be because SECA tax is $90 lower than it should be. If that individual's marginal income tax rate is 25 percent, the understatement of the deduction would increase income tax by $11.25. Taking that income tax offset into account, the total tax saving from the error in the SECA computation for that individual is $90 less $11.25, or $78.75.

Potential Increase in Social Security Benefits

Self-employment earnings for purposes of computing Social Security benefits are reduced by half

1.4293 percent and the tax rate 2.9 percent, making the payroll tax for that range of earnings $21.19. Currently, the deduction is 7.65 percent and the tax rate is 15.3 percent, making the payroll tax for that range of earnings $104.76. So that error reduces the payroll tax cut at $126,692 of earnings by $104.76 less $21.19, or $83.57. But even with the reduction, there is a payroll tax cut at that level of earnings, and the cut increases as earnings rise above that level.

[8]The self-employed worker is assumed to be single, so the surtax should begin at earnings of $210,154, but it begins at $216,567. Between those earnings amounts, the 0.9 percent surtax should apply but it does not. That increases the payroll tax cut by an additional $57.72.

[9]For high-income taxpayers, a 3.8 percent surtax on net investment income applies to the lesser of NII or AGI in excess of a threshold level. By increasing AGI, the understatement of the employer-equivalent share of SECA can increase the surtax in some circumstances by increasing income above the level at which the surtax applies and by increasing the surtax base by increasing AGI in excess of a threshold level.

of SECA liability (excluding the surtax), so the error in the computation carries over to the calculation of Social Security benefits. However, Social Security benefits are based only on earnings up to the OASDI cap, so it is only the error in the employer-equivalent portion of SECA on earnings up to the cap that might affect benefit calculations. That error is relatively small. For example, a self-employed worker with $107,650 of earnings has an amount comparable to wages of $100,000, but the amount that individual reports for Social Security purposes is $45 higher.

A Legislative Correction

Lawmakers recognize the error in the SECA computation. The Camp plan would correct the formulas, making the OASDI cap adjustment factor 1.0765 and making the deduction 7.1064 percent for self-employment earnings below the adjusted cap and 1.4293 percent for earnings above it. The correction would carry through to both the income tax deduction and the amount of self-employment earnings used for computing Social Security benefits. The Joint Committee on Taxation's estimate for that provision of the Camp plan (including the income tax offset) is a revenue gain of $5.1 billion between 2015 and 2023. The Social Security and Medicare trust funds would increase by more than $5.1 billion.

Correcting the error in the SECA computation would both remove an inequity and raise revenue. The necessary legislative language is already drafted and it's hard to think of an easier step for Congress to take toward tax reform.