

The Optional Method of Paying Self-Employment Tax*

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Introduction

A self-employed individual must pay self-employment (SE) tax on earned income to be entitled to receive social security benefits. These benefits include retirement, disability, and survivor benefits as well as Medicare coverage, all of which are important to agricultural producers. To qualify for these benefits, a producer must have contributed by paying self-employment taxes and earning the required quarters of coverage. For additional information about self-employment taxes, refer to the fact sheet “If You Are Self-Employed” in the Related Articles section found on the RuralTax.org website.

Social Security Benefits

Retirement benefits are paid only if the individual has at least 40 quarters of coverage. A quarter is 3 months of coverage. This means that the farmer must have paid into social security for 10 years (these are not required to be consecutive) or have been born before 1929.

Disability benefits can be paid to individuals who pass the recent-work test and the duration-of-work test.

- To pass the recent-work test, an individual must be currently insured, have 20 quarters of coverage (worked at least five of ten years before the disability occurred), and be at least 31 years old during the quarter of the year they become disabled. If the individual is younger than 31, the “qualifying work period” is half of the work period beginning when the individual turns 21 and ending with the quarter in which the individual became injured.

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- The duration-of-work test looks at the individual's lifetime work history. For example, it requires 6 quarters of work for an individual who becomes disabled before age 28, 2 years (8 quarters) for a 30-year old, 6 years (24 quarters) for a 46-year old, and 9.5 years (38 quarters) for a 60-year old individual.

Survivor benefits may be paid to:

- A. widows and widowers who meet age criteria,
- B. unmarried children under age 18 (age 19 if attending high school),
- C. children of any age who were disabled before the age of 22 and remain disabled, and
- D. dependent parents who are at least 62.

Survivor benefits may require up to 10 years of work credits. Children can receive benefits if the worker had at least 1.5 years of work during the 3 years before death.

Self-Employment Income and Coverage Credits

Earnings from self-employment are used to determine the number of credits earned annually, for a maximum of four credits earned per year. For 2015, a quarter of credit is acquired for each \$1,220 of income. If earnings are equal to or greater than \$4,880 ($\$1,220 \times 4$) the farmer will earn the four credits for 2015. It does not matter if all income is earned in the first quarter or spread between two or more quarters.

Farm "Optional Method"

Farmers and ranchers often experience years of low income or losses which results in years with no credits being earned. If income from the farm operation subject to self-employment taxes is less than \$400, no self-employment tax is owed. Since no SE tax is owed, no social security coverage credits are earned for that year. To earn one quarter of coverage, net farm income must be at least \$1,220 for 2015. Therefore, for 2015, net farm income must be equal to or greater than \$4,880 to earn 4 quarters of coverage. This amount is adjusted annually.

However, in cases where the self-employed farmer (and to a lesser degree self-employed non-farmer) does not meet these criteria, they have the ability to use the "optional method" of coverage during years of low income or losses thus granting them with coverage even though little or no profit is shown. The farmer must meet either of the following tests to use the farm optional method for determining SE tax: gross farm income is \$7,320 or less, or net farm profits are less than \$5,284. Also for 2015, the SE tax rate is 15.3% (12.4% for FICA and 2.9% for Medicare).

The following examples¹ explain how each of the tests work in the calculation of the number of coverage credits for a farmer when gross farm income is less than \$7,320 (Example 1) and more than \$7,320, but the net farm profits are less than \$5,284 (Example 2). The deemed earnings for the optional method and the cost of self-employment tax are illustrated for 2015. The deemed earnings are the smaller of two-thirds of gross farm income or the lower limit (the amount needed for 4 quarters of coverage).

¹ These examples are modified from Philip E. Harris. *Agricultural Tax Issues*, Fall 2011, pp. 85-86.

Example 1: Gross Farm Income is Less Than \$7,320

Lisa Farmer has \$6,000 of gross farm income and a net loss (total income minus total expenses) on her 2015 Schedule F (Form 1040). The regular method of calculating the SE tax will result in no SE tax liability and therefore no quarters of coverage. Should she choose to use the farm optional method, Lisa can report \$4,000 (which is two-thirds of her 6,000 gross farm income) as her earnings from self-employment. Lisa's SE tax will be \$612 ($\$4,000 \times 15.3\%$) and she earns 3 quarters of coverage ($\$4,000$ of reportable earnings \div $\$1,220$) for social security benefits.

Example 2: Gross Farm Income More Than \$7,320 (but net income is less than \$5,284).

Josh Farmer has \$7,500 of gross farm income and \$2,500 of net farm income in 2015. Computing his SE tax using the regular method will result in a \$353 ($\$2,500 \times 0.9235 \times 15.3\%$) SE tax liability and 2 quarters of coverage ($\$2,500$ net farm income \div $\$1,220$ the amount needed for 1 quarter of coverage). If Josh elects the optional farm method, he can report \$4,880 (the lower limit) as his 2015 earnings from self-employment. He will owe \$747 ($\$4,880 \times 15.3\%$) of SE tax and earn 4 quarters of social security coverage.

By using the "optional method" of paying self-employment taxes in years of low or negative net farm income, a producer will ensure that they will qualify for retirement, disability, and survivor benefits, providing they meet the 20 or 40 quarter requirements. A farmer can also use the optional method as often as needed to accumulate quarters of coverage since there is not a limit on the number of years a farmer can use the optional method. This is not true for those filing a schedule C. Taxpayers can elect the optional method of computing SE tax on an amended return for open tax years 2012 or later.

IRS Publications

Additional information concerning business start-up costs can be found in Chapter 7 of IRS Publication 535; Business Expenses.

To access IRS forms and publications, go to www.irs.gov and click on "Forms and Publications". Then click on "Publication number" under "Download forms and publications by:" Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers,

and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

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