



# Current Report

*Division of Agricultural Sciences and Natural Resources • Oklahoma State University*

## Self-Employment Tax

Shannon Ferrell  
Extension Assistant

Mike Hardin  
Extension Tax Specialist

Chris Petermann  
Extension Associate

Damona Doye  
Extension Economist

**Note:** This publication is intended to provide general information about legal issues. It should not be cited or relied upon as legal authority. State laws vary and no attempt is made to discuss laws of states other than Oklahoma. For advice about how these issues might apply to your individual situation, consult an attorney.

### What is the self-employment tax?

Individuals who work for someone else are usually subject to Social Security and Medicare taxes that are paid for by withholdings from their wages. The self-employment tax is designed to treat individuals who work for themselves in a similar manner, by taxing income that comes from self-employment and crediting those taxes to Social Security and Medicare coverage, just as it would be done for an employee.

### Do I need to pay the self-employment tax?

According to the IRS, you are self-employed if you carry on your own trade or business as a sole proprietor (i.e., you are the only owner of the business), an independent contractor, a member of a partnership, or are otherwise in business for yourself. Thus, you are usually self-employed if you operate a farm on land you either own or rent.

For share-farmers, additional criteria determine whether you are self-employed. If you produce a crop or raise livestock on land belonging to another person, and your share of the crop or livestock (or the proceeds from the sale of such commodities) depends on the amount produced, then you are a self-employed farmer. An example of this is an arrangement where a share-farmer receives two-thirds of a crop.

If, on the other hand, you receive a specified rate of pay or a fixed amount of the crops or livestock, you may be self-employed or an employee of the landlord. The determination

will be made by whether you are under the direction of the landlord. If you direct how and when the operations of the farm are carried out, then you are self-employed. If the landlord has the right to direct your activities, you are an employee and not subject to self-employment taxes. Let us say that you are paid \$10,000 per year for farming a given portion of land, regardless of crop yield or prices. If the landlord does not direct you as to how to carry out the operation of the farm (i.e., when and what crops to plant, how they are to be cultivated, when they should be harvested), then you are self-employed. On the other hand, if you are paid the specified \$10,000 and the landlord does provide the directions specified above, you are an employee and not subject to the self-employment tax. Instead, your employer should treat you as employee and make the appropriate withholdings from your payment.

Under the IRS code, you need to pay self-employment taxes if you earn more than \$400 from self-employment in the tax year. See Table 1 for a listing of specific examples of items that are and are not self-employment income.

Even if you do not have to pay self-employment taxes, it may be a good idea to pay them anyway under the "farm optional method" discussed at the end of this article. Your Social Security income is proportionate to the amount of your contributions through wage withholdings and self-employment taxes. If you choose to avoid the self-employment tax, you should be sure to plan for an additional source of income to supplement or replace your Social Security income.

**Note:** You must have a Social Security number to pay the self-employment tax. If you don't have one, you need to fill out form SS-5 (Application for a Social Security Card). This application can be obtained from any Social Security office or by calling 1-800-722-1213.

### Is my income from rents and leases subject to the self-employment tax?

As a general rule, income from rentals and from personal property leased with real estate are not taken into account to determine net self-employment income. However, income from farm rentals and from personal property leased with the

real estate (including government commodity program payments received by a landowner who rents out land) is taken into account if the rental agreement provides that the landlord will materially participate in the production or management of production of the farm products on the land. This also holds true if the landlord's participation is not provided for in the rental agreement, but the landlord materially participates anyway.

"Material participation" is defined as playing a substantial role in the management of an operation. Four tests determine if you materially participate in the management of a farm. These tests are as follows:

- 1) You do any three of the following four activities:
  - Pay or stand good for at least half of the direct costs of raising the crop.
  - Furnish at least half of the tools, equipment, and livestock used in producing the crop.
  - Consult with your tenant.
  - Inspect the production facilities periodically.
- 2) You regularly and frequently make, or are an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
- 3) You work more than 100 hours, spread over a period of five weeks or more, in activities connected with crop production.
- 4) You do things which, considered in their total effect, show that you are materially and significantly involved in the production of farm commodities.

If you did any one of these four things, you are considered to have materially participated in the farm enterprise.

In addition, rent paid in the form of crop shares is included in self-employment income for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your net earnings from self-employment under the Farm Optional Method includes the fair-market value of the crop shares when they are used as feed.

## How do I calculate my self-employment taxes?

Basically, there are three steps to calculating your self-employment taxes.

- 1) Figure your net self-employment income.
- 2) Figure your net earnings from self-employment.
- 3) Multiply your net earnings by the tax rate.

We will discuss these steps in more detail:

### Step 1 – Figure your net self-employment income

Net self-employment income usually includes all farm and non-farm business income less all business deductions allowed for income tax purposes. You must claim all allowable deductions when figuring net self-employment income.

You must figure your net income from self-employment by using the same accounting method (i.e., cash or accrual) you use for income tax purposes. Net self-employment income can be found on the following lines and schedules:

- Schedule F (Form 1040) ..... Line 36
- Schedule K-1 (Form 1065) ..... Line 15a
- Schedule C (Form 1040) ..... Line 31
- Schedule C-EZ (Form 1040) ..... Line 3

Do not reduce your self-employment income by the following deductions:

- Deductions for personal exemptions for yourself, your spouse, or dependents.
- The standard deduction or itemized deductions.
- The net operating loss deduction.
- Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing plan, annuity plan, Keogh or SEP plan.
- The self-employment health insurance deduction.

### Step 2 – Figure your net earnings from self-employment

There are three ways to figure net earnings from self-employment:

- 1) The regular method
- 2) The farm optional method
- 3) The non-farm optional method

For simplicity, we will demonstrate the regular method. However, it may be to your advantage to use the farm optional method, described later in this report.

If you are using the regular method, take the net self-employment income you calculated in step 1, and multiply by 92.35% (0.9235). The result is your net earnings from self-employment.

### Step 3 – Multiply your net earnings by the tax rate

Multiply the net earnings you figured in step 2 by the tax rate to figure your self-employment tax. For 1998, this rate was 15.3% (0.153).<sup>1</sup> This is a composite of the 12.4% Social Security tax and the 2.9% Medicare tax. Note that income over \$68,400 is exempt from the Social Security portion of the tax. Thus, if you had self-employment income over \$68,400, multiply the amount up to that level by the 15.3% rate, and multiply any income above that level by 2.9% (the Medicare portion of the tax has no upper limit on the amount of income to which it can apply).

## What is the farm optional method of calculating net earnings from self-employment, and when can it be used?

The farm optional method of calculating net earnings from self-employment can be used if you meet one of the

<sup>1</sup> For current rates, consult one of the IRS references listed, e.g., 225, - "Farmer's Tax Guide," or 533, "Self-Employment Tax."

following conditions:

- If your gross income from farming is \$2,400 or less, you can simply report two-thirds of this gross income as your net earnings from farm-self employment, regardless of what your net earnings from farm self-employment were (see Example 1 below), or.
- If your gross income from farming is more than \$2,400, and your net farm profits (as shown on line 26 of Schedule F [Form 1040] and line 15a of Schedule K-1 [Form 1065]) are less than \$1,733, you can report \$1,600 as your net earnings from self-employment (see Example 2 below).

This method may mean paying self-employment taxes when they wouldn't have to be paid. However, this can be to your advantage, as we will explain later.

Here are two examples of self-employment taxes:

**Example 1:** Tom Smith's small farming operation generated \$2,300 of income this year and had \$2,000 of expenses. Net earnings are \$300. Since he earned less than \$400, he is not required to pay self-employment taxes. However, under the optional method's first requirement, he can report \$1,533 ( $\$2,300 \times 2/3 = \$1,533$ ) as his net earnings from farm self-employment. This would mean that Tom owes \$235 in self-employment taxes ( $\$1,533 \times 15.3\% = \$235$ ).

**Example 2:** Bob Jones has \$30,000 of gross farm income, but \$29,750 of farm expenses. Thus, his net farm profits are \$250. Again, since individuals with less than \$400 of net income from self-employment are exempt from self-employment taxes, Bob would not need to pay any such taxes. However, under the optional method's second requirement, he could choose to report \$1,600 as net earnings from self-employment. This would mean that Bob owes \$245 in self-employment taxes ( $\$1,600 \times 15.3\%$ ).

## Why would someone want to use the farming optional method?

Farmers may want to pay self-employment taxes even when it is not required because of the way that Social Security and Medicare benefits are earned.

### How social security benefits are earned

Coverage under the Social Security and Medicare systems is based on the concept of "quarters of coverage," also called "credits." In 1998, a credit was given for every \$700 of wages subject to Social Security and Medicare wages, up to a maximum of four credits per year. The amount needed to earn a credit is indexed to inflation, and thus will change each year. The number of credits is determined by dividing the amount of taxable wages by the amount needed to earn a credit, and rounded down to the nearest whole number. Let's say you earn \$2,450 of taxable wages.  $\$2,450 \div \$700 = 3.5$ . This is rounded down to 3 credits earned. In the examples above, Tom Smith

would have earned two credits, since  $\$1,535 \div \$700 = 2.19$ . Bob Smith would also earn two credits since  $\$1,600 \div \$700 = 2.29$ . Neither person would have earned any credits if they had not used the farm optional method.

### Credits required for coverage

Various types of coverage under the Social Security and Medicare systems require different amounts of credits to be earned before an individual can receive their benefits. A person is fully insured if they have either 40 credits, or if they have at least six credits and a credit for each year the worker is older than 21. To qualify for retirement benefits, a person must be fully insured.

Workers are currently insured if they meet the standard for their age:

- Workers under age 24 are currently insured if they have six quarters of coverage in the three-year period ending when their disability begins.
- Workers age 24 through 31 must have credits for half the difference between age 21 and the age of disability. The "difference" is measured in quarters. If a person was 29 when they were disabled, the difference between 21 and their age would be 8 years, or 32 quarters. To be currently insured, they would need to have earned half that number of credits, 16.
- Workers over age 31 must meet a minimum number of credits that varies depending on their age and generally must have earned 20 quarters of coverage in the 10 years immediately before they became disabled.

A worker can receive disability payments only if he or she is currently insured. To qualify for other non-retirement benefits such as survivor's benefits and lump-sum death benefits, the worker must be either fully insured or currently insured. Given the requirements of Social Security's various programs, it is generally a good idea to earn at least two credits per year to maintain coverage.

### An example of the importance of the farm alternative method

Since credits must be earned to become eligible for certain benefits, it may be advantageous to pay self-employment taxes, even though such payments might not be required. This is where the farm optional method of calculating self-employment taxes may be useful. The following example illustrates this.

John and Mary Farmer were married and started a farming operation in 1986. John was born on July 14, 1964, and thus was 22 years old when he began farming in 1986. His son, John Jr., was born in 1989, and his daughter, Marie, was born in 1991.

John used aggressive tax planning in the profitable years and had several years of losses during the first 10 years of farming. Consequently, he showed no farm profits for the first 10 years. His gross farm income and net farm profit for 1993 through 1996 are shown on the following page.

<b>Year</b>	<b>Gross Farm Income</b>	<b>Net Farm Profit (Loss)</b>
1993	\$25,158	\$(8,968)
1994	\$37,289	\$(5,662)
1995	\$28,305	\$(7,421)
1996	\$64,222	\$3,200

John did not choose to use the farm optional method to figure his self-employment taxes; instead, he used the regular method and had no self-employment taxes. As a result, he received no credits for Social Security coverage, except for four credits earned in 1996:  $\$3,200 \div \$640$  (the amount required to earn one credit in 1996) = 5 (but only 4 credits can be earned in a year).

On December 14, 1996, John died in an automobile accident. Since he had not accumulated any credits for coverage, his family was not eligible for Social Security survivors' benefits. Such benefits required 40 credits (the general rule) or 10 credits (under the rule that requires one credit for each year after the age of 21, not counting the year

of death and requiring a minimum of six credits).

If John had used the farm optional method, or if Mary had filed amended returns for 1993, 1994, and 1995 before April 15, 1997, he would have been able to earn six additional credits. Under the farm optional method, if gross income from farming is more than \$2,400, but net farm profit is less than \$1,733, a farmer can report \$1,600 as net earnings from farm self-employment. Thus, John could have claimed two credits in each of the years when there were farm losses:

- 1993:  $\$1,600 \div \$590 = 2.71$ , rounds to 2 credits
- 1994:  $\$1,600 \div \$620 = 2.58$ , rounds to 2 credits
- 1995:  $\$1,600 \div \$630 = 2.53$ , rounds to 2 credits

These six credits, when combined with the four earned in 1996, would have given him the required 10 credits, and thus made his family eligible for widow's or survivors' benefits.

So, even if you are not be required to pay self-employment taxes, be aware that it may be in your best interest to do so in order to maintain your Social Security coverage.

**Table 1 – Examples of Items Considered and Not Considered to be Self-employment Income**

***Specific Items Considered to Be Self-employment Income***

- Taxable patronage dividends (distributions) from cooperatives.
- Government agricultural program payments, including commodity program payments, and conservation reserve program (CRP) payments.
- Taxable commodity credit loans.
- Storage fees paid by the Commodity Credit Corporation under a resale agreement to farmers for storing their own grain.
- Refunds or rebates, if they represent a reduction in a deductible expense item, including fuel tax credits.
- Prizes or awards on farm produce or livestock.
- Crop damage payments.
- Value of merchandise received for farm products.
- Standing crop sales, if not sold with land that was held more than one year.
- Crop shares received as rent.<sup>2</sup>
- Any amounts for depreciation, including any section 179 deduction, recaptured because the business use of the property was reduced to 50% or less (this does not include amounts recaptured on the disposition of property).
- Lost income payments received from insurance or other sources for reducing or stopping farming activities. Even if you are not farming when you receive the payment, it is self-employment income if it relates to your farm business (even though it is temporarily inactive). A connection exists if it is clear that the payment would not have been made but for your conduct of your farm business.
- If you participate in a partnership, your distributive share of income or loss from your partnership's trade or business.

***Specific Items Not Considered to be Self-employment Income***

- Rent from real estate and from personal property leased with real estate is not self-employment income if you are a landlord and do not materially participate in the farming operation. It does not matter if the rent is received in crop shares, cash, or other property. This rule applies if the landlord does not materially participate in the production or management of production of farm products on the land.
- Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.
- Dividends on securities are not self-employment income, unless you are a dealer in securities.
- A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included in self-employment income:
  - ✓ investment property.
  - ✓ depreciable property or other fixed assets used in your trade or business.
  - ✓ livestock held for draft, dairy, breeding, or sporting purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether raised or purchased.
  - ✓ standing crops sold with land held more than one year.
  - ✓ timber, coal, or iron ore held for more than one year, if such an economic interest was retained, such as the right to receive coal royalties. A gain or loss from the cutting of timber is not included if the cutting is treated as a sale or exchange.
- Wages received for services performed as an employee and covered by Social Security or railroad retirement are not self-employment income.
- A limited partner figures net self-employment income by excluding the distributive share of partnership income or loss, but guaranteed payments received for services performed are included in self-employment income.
- A retired partner does not include retirement payments received from the partnership under a written plan that provides for lifelong periodic payments as long as the retired partner's capital interest has been fully paid and the partner provides no services for the partnership.

<sup>2</sup> Refer to the section "Is my income from rents and leases subject to the self-employment tax?" for further explanation.

## **The Oklahoma Cooperative Extension Service**

### ***Bringing the University to You!***

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; home economics; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective and based on factual information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

Oklahoma State University, in compliance with Title VI and VII of the Civil Rights Act of 1964, Executive Order 11246 as amended, Title IX of the Education Amendments of 1972, Americans with Disabilities Act of 1990, and other federal laws and regulations, does not discriminate on the basis of race, color, national origin, sex, age, religion, disability, or status as a veteran in any of its policies, practices or procedures. This includes but is not limited to admissions, employment, financial aid, and educational services.

Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Samuel E. Curl, Director of Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Dean of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of \$682.41 for 2,000 copies. #4354 0299 SF/MS.C.