

Self-Employment Tax*

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Introduction

Most taxpayers working for an employer have FICA and Medicare withheld from their wages. The amount withheld is matched by their employer. Consequently, they will receive retirement and medical benefits when they reach retirement age. They are also entitled to disability and survivor benefits. The self-employed individual must pay self-employment (SE) tax to be entitled to similar benefits. This is paid when they file their federal income tax return. The SE tax rates equate to both the employer's and employee's share of FICA and Medicare.

Self-Employment Income

Any income other than salary or wages is "earned income." Therefore, a person operating a farm or ranch that they own or rent must pay SE tax on the net farm income. A person must "actively participate" in the operation to have SE income. The income and expense is reported on Schedule F, *Profit or Loss from Farming*. A cash rent landowner is not liable for the SE tax on the rents and reports the rents on Schedule E, *Supplemental Income and Loss*. Typically, a share crop landlord does not owe SE tax unless they "materially participate" in the day-to-day operation of the business. Then the share crop income is reported on Form 4835, *Farm Rental Income and Loss*. A person that farms on a contract basis, such as a hog or poultry operation, has SE income as he or she normally assumes some of the risk.

One area of concern is the treatment of conservation reserve payments (CRP). The final

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determination by the IRS is that CRP payments received by a farmer are self-employment income unless the recipient is receiving social security or railroad retirement income.

SE Tax Computation

For 2024, the SE tax rate is 12.4% of the first \$168,600 of net business income and the Medicare rate is 2.9% of the amount of net business income. If the income subject to SE tax is less than \$400, there is no SE tax due and the Schedule SE, *Self-Employment Tax*, is not filed.

However, there may be reasons to complete the schedule and pay SE tax under an optional method. This is discussed later.

Note. There is an exception for certain religious sects that oppose any public or private insurance. This exemption is available only if both the employee and employer are members of the sect. They can file for an exemption with Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits*.

Generally, farmers having employees must withhold social security and Medicare tax on all cash wage payments, as well as pay the employer's share of social security and Medicare tax. All cash wages paid to employees is subject to social security and Medicare tax withholding if either of the two tests is met:

- 1) If a farmer pays cash wages to an employee of \$150 or more, this applies separately for each employee, or
- 2) the total wages paid for farm work is \$2,500 or more.

The social security tax rate is 6.2% and the Medicare tax rate is 1.45% for both the employee and employer. An employer must withhold at this rate as well as pay a matching amount.

If the farmer hires a neighbor to do custom work, the neighbor could be either an employee or an independent contractor, depending on the facts and circumstances. If the person is an employee, the farmer must pay the employer's share of payroll taxes. However, if the person is an independent contractor, the custom operator is considered self-employed and must pay his/her own SE tax. A classification problem can occur if the custom operator uses the farmer's equipment. The IRS has a 20-prong test they use to determine whether the individual is an employee or an independent contractor. None of the tests is determinative, as the final decision is based on the results of all of the questions. One very important question is, "Who furnishes the tools of the trade and determines the work schedule?"

If the farm is operated as a C or S corporation and the farmer is paid a wage by the corporation,

social security and Medicare taxes are withheld from his/her wages. If the farm is operated as a partnership, the farmer's entire share of net business income is subject to SE tax and Medicare.

Why Pay SE Tax?

For many smaller operations, a farmer's SE tax liability can be greater than the income tax liability.

Example 1:

John and Lucy Farmer are married and have two children (10 and 12). Lucy is not employed during 2024. John grows vegetables and sells them at a local market. During 2024, John's net profit was \$70,000. John did not sell any equipment and John and Lucy had no other source of income. For 2024, the Farmers have \$4,071 of income tax liability and have a \$9,891 ($\$70,000 \times .9235 \times 15.3\%$) SE tax liability.

Consequently, the farmer may desire to develop a tax plan around a strategy to minimize or even avoid SE tax liability. This may not be the best option. Due to the hazardous nature of farming, a farm operator is more likely to become disabled than a worker in most other occupations. Unless he or she has private disability insurance, disability can cause severe financial problems.

Social security disability payments are based on two different earnings tests:

- 1) A "recent work" test based on the age of the person at the time he or she became disabled; and
- 2) A "duration of work" test to show that the person worked long enough under social security.

Social security and disability benefits are based on the number of credits earned. In 2024, one credit is earned for each \$1,730 of net earnings. A maximum of four credits can be earned each year. Taxpayers turning 31 years old in the quarter or later must have 20 credits and work 5 years out of the 10-year period ending with the quarter in which the disability begins. Younger workers can obtain disability benefits with as little as 1.5 years of work during the three-year period ending with the quarter the disability began.

The "duration of work" time period also varies. If an individual becomes disabled before age 28, 1.5 years of work are required. If an individual becomes disabled at age 62 or older, 10 years of work and 40 credits are required. Individuals between 28 and 60 require various credit amounts and years of work.

If a taxpayer dies, survivor benefits may be available to the spouse and family members. The credit requirements are the same as those for disability benefits.

The following table shows the dollar amount of earnings required for one quarter of coverage from 2009 to 2024.

Year	Earnings for 1 Quarter of Coverage	Year	Earnings for 1 Quarter of Coverage
2009	1,090	2017	1,300
2010	1,120	2018	1,320
2011	1,120	2019	1,360
2012	1,130	2020	1,410
2013	1,160	2021	1,470
2014	1,200	2022	1,510
2015	1,220	2023	1,640
2016	1,260	2024	1,730

Husband and Wife Partners

If the farming operation is jointly owned and operated by a husband and wife, a partnership tax return is required to be filed. IRS regulations allow the husband and wife to opt out of filing Form 1065, *U.S. Return of Partnership Income*, and instead file two Schedule Fs. This will cause each spouse to report one-half of the income and expenses on their separate Schedule F. It will also cause each spouse to pay SE tax on his/her share of the farm net income. Each spouse will then be adding to their individual social security account. While this may create a reduction of total social security benefits for the couple, it may provide disability benefits if either husband or wife becomes disabled. It could also be beneficial if the couple divorces.

Optional SE Tax

As previously discussed, SE tax is paid on the net profit of the farm or ranch. However, not all farms and ranches are profitable in all years. Therefore, Congress has enacted special provisions that allow a farmer to make SE tax payments in unprofitable years. This is called an “optional SE tax payment.”

In years with losses or low income, farmers should seriously consider paying the optional SE tax in order to protect disability benefits. In addition to providing disability protection, the optional method may increase the

- Earned income credit,
- Additional child credit,
- Child and dependent care credit, and
- Self-employed health insurance deduction.

The farm optional method can be used to calculate net earnings from farm self-employment. For

2024, gross farm income must be \$10,380 or less, or net farm income must be less than \$6,920 (2/3 of \$10,380) to use the optional method. Using the optional method will provide four quarters of credit for the year. The cost of the coverage for \$6,920 of net income will be \$1,059 ($\$6,920 \times 15.3\%$).

There is no limit to the number of years a farmer can use the optional method. For additional information about the optional method of paying self-employment taxes, refer to the fact sheet “The Optional Method of Paying Self-Employment Tax” in the Related Articles section found on the RuralTax.org website.

Amended Returns

If a farmer finds he does not have enough quarters of coverage to qualify for disability or survivor benefits, he should consider filing amended tax returns. The returns for the three prior years can be amended and the optional method computed. This could allow the farmer to meet the recent work and duration of work tests.

Example 2:

Tim and Lydia Rancher were married and started ranching in 2014. Tim was born July 4, 1992, and was 22 years old when he started ranching. A son was born in 2018 and a daughter was born in 2020. After paying substantial self-employment tax in 2020 and 2021, Tim used aggressive tax planning and reported losses in 2022 and 2023.

Consequently, he only obtained 12 credits of coverage for the first 10 years of ranching. In 2024, Tim was killed in an automobile accident. Because he did not have 20 credits, his widow and children are not eligible for survivor benefits.

Fortunately, Lydia can amend the 2022 and 2023 income tax returns and claim the optional method. This will give Tim four quarters of coverage in each of those two years for a total of 20 quarters of coverage. This will make her eligible for survivor benefits.

IRS Publications

For more information on or to access Schedule E, Schedule F, Form 1065, or Form 4835, visit the IRS website at 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.

IRS Publication 225, Farmer's Tax Guide. Chapter 12 discusses self-employment tax issues.

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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