



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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HUMAN RESOURCES
DIVISION

June 30, 1983

B-204985

The Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Subject: Self-employed Fiscal Year Taxpayers Can Receive
an Advantage Compared to Self-Employed Calendar
Year Taxpayers at the Social Security Trust
Funds' Expense (GAO/HRD-83-45)

In May 1981, you requested that we review the Social Security Administration's (SSA's) accuracy in posting self-employed earnings amounts to individuals' earnings records. While doing our work, we discovered an inequity between the tax treatment of taxpayers reporting on a fiscal year basis and those reporting on a calendar year basis.

The number of fiscal year self-employed taxpayers is very small, about 7,400 of the estimated 7.6 million self-employed covered by social security. However, they enjoy a slight financial advantage over calendar year taxpayers. This advantage translates into about \$17.7 million over the working and retirement lifetime (about 63 years) of the 7,400 people. The advantage could be eliminated by amending the Social Security Act to provide that earnings credited to an individual's earnings record for any calendar year be taxed at the rate and up to the earnings ceiling in effect for that year. But given the small number of taxpayers involved, the small amount of money involved, and the possible additional administrative burden placed on SSA and the Internal Revenue Service (IRS), we do not recommend that action be taken. An inequity does exist, however, and it is because of this inequity that we are advising you of the situation.

The Social Security Act Amendments of 1983 raised the self-employment tax rates from about 70 percent to 100 percent of the combined employee-employer tax rate effective January 1, 1984, and accelerated the previously scheduled tax rate increases. Consequently, the effect of the advantage that fiscal year taxpayers currently enjoy over calendar year taxpayers will be further increased on January 1, 1984.

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To determine social security coverage and benefit amounts for self-employed calendar year taxpayers, social security credits net self-employment earnings to an individual's earnings record for the calendar year in which they are earned. The earnings are taxed at the rate and up to the earnings ceiling in effect for the calendar year. In contrast, social security credits fiscal year taxpayers' earnings to their earnings records by proportionately allocating such earnings by month to each of the calendar years that the fiscal year spans. However, all the fiscal year earnings are taxed at the rate and up to the earnings ceiling in effect at the beginning of their fiscal year. Thus, fiscal year taxpayers receive a tax advantage whenever the social security tax and/or earnings ceiling is raised, because they avoid the tax increase on that portion of their fiscal year earnings credited to the next calendar year.

The following example illustrates the tax advantage fiscal year taxpayers receive. In the example, the fiscal year taxpayer has a July 1 to June 30 fiscal year.

	<u>Calendar year 1981 earnings</u>	<u>Tax rate</u>	<u>Tax</u>
Calendar year taxpayer	\$20,000	9.3%	\$1,860
Fiscal year taxpayer:			
FY 1981 (Jan. 1 to June 30)	10,000	8.1% (1980 rate)	\$810
FY 1982 (July 1 to Dec. 31)	10,000	9.3% (1981 rate)	<u>1,740</u>
Tax advantage for fiscal year taxpayer			<u>\$ 120</u>

Of course, as earnings approach the earnings ceiling, the tax savings for a fiscal year taxpayer are greater. Because the Social Security Act Amendments of 1983 both increased the tax rate for self-employed taxpayers from 70 percent to 100 percent of the employee-employer rate and accelerated the scheduled tax rate increases, the tax advantage will be magnified. For instance, the 1984 tax savings for the same fiscal year taxpayer with the same earnings assumed in the example above will be \$195 after taking into account the 2.7-percent tax credit permitted the calendar year taxpayer to partially offset the tax rate increase.

While fiscal year taxpayers pay less taxes than calendar year taxpayers with the same earnings, this advantage is usually partially offset because fiscal year taxpayers receive a lower social security retirement benefit. This occurs because fiscal year taxpayers' final year of earnings, after allocation, represents only a partial year for benefit computation purposes, since benefits are computed on a calendar year basis. Both situations considered, however, fiscal year taxpayers receive a net advantage over calendar year taxpayers equal to about 2.5 percent of social security taxes paid during their lifetimes. This is illustrated by the example presented in enclosure I.

Until 1971, fiscal year taxpayers' earnings were subject to the tax rate and ceiling in effect at the end of the the fiscal year. In that year the Congress changed to the current system of tax rates and earnings ceilings in effect at the beginning of the taxpayer's fiscal year. These provisions were changed to relieve fiscal year taxpayers of the tax burden created by the application of the later year tax rate and ceiling to total fiscal year earnings. The change corrected that situation, but created the present one. We found no indication in the legislative history that pro-rating earnings for tax purposes was considered.

Equity between fiscal and calendar year self-employed workers can be achieved by allocating fiscal year earnings proportionately between calendar years and taxing earnings at the rates and ceilings in effect for those years. Adopting this method would necessitate a change in the IRS instructions to taxpayers so that fiscal year taxpayers could pro-rate their earnings and calculate the correct tax. In addition, both the Social Security Act and the Internal Revenue Code would have to be amended to permit taxing of earnings as allocated to calendar years.

IRS and Department of Health and Human Services (HHS) officials agree that an inequity exists, but do not believe the Social Security Act should be amended because of the additional administrative effort required to implement the change. HHS said such a change would complicate SSA's computation and reporting of self-employment tax liability data to the Treasury at a time when SSA is undertaking a computer system modernization and would generate little savings to the trust funds.

IRS Legislative Analysis Division officials said they believed that significant administrative costs would be incurred if the changes were made because

- a new Schedule SE would have to be designed,
- the resulting schedule and instructions would be so complex that taxpayer errors would increase, and
- IRS processing and review time would increase.

HHS and IRS may be overstating the administrative burden involved in modifying the taxation of fiscal year taxpayers. For example, an SSA official stated that the reprogramming necessary to effect needed changes to SSA's reporting of tax liability would require less than one staff year of effort. Also, a new Schedule SE, which would affect all 7.6 million self-employed taxpayers, may not be necessary. Rather, a worksheet, as part of Publication 533 "Self-Employment Tax," could be developed for use by the 7,400 self-employed fiscal year taxpayers. Currently, the Schedule SE makes no reference to fiscal year filers. A fiscal year taxpayer must refer to Publication 533 for instructions.

We have not examined the basis for SSA's and IRS's reservations in sufficient detail to conclude whether their concerns should preclude such a change. Further analysis would require determining the feasibility and administrative costs of implementing a change in the self-employment tax instructions and the impact on SSA of any change in how SSA reports and records earnings and tax liability. We would be willing to undertake such an assessment if the Committee believes the issue is worth pursuing further.

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As arranged with your office, unless you publicly announce its contents earlier, we will make no further distribution of this report for 3 days. At that time, we will send copies to interested parties and make copies available to others on request.

Sincerely yours,



Richard L. Fogel
Director

Enclosures - 2

ILLUSTRATION OF FISCAL YEAR TAXPAYER ADVANTAGECOMPARISON OF SOCIAL SECURITY SELF-EMPLOYMENTBENEFIT AND TAX DATA FOR PERSONS WITHAVERAGE AND MAXIMUM EARNINGSBASED ON CALENDAR AND FISCAL YEAR REPORTING^a

(1983 DOLLARS)

<u>Average earner</u>	<u>Calendar year reporting</u>	<u>Fiscal year reporting</u>	<u>Difference</u>
Taxes paid (1980-2024)	\$ 93,628	\$ 90,646	\$2,982
Retirement benefits received (2025-2043)	142,748	142,152	<u>(596)</u>
Fiscal year taxpayer advantage			<u>\$2,386</u>

Net tax advantage to fiscal year taxpayer as a percentage of taxes paid by calendar year taxpayer is 2.5 percent (2,387 divided by 93,628).

<u>Maximum earner</u>	<u>Calendar year reporting</u>	<u>Fiscal year reporting</u>	<u>Difference</u>
Taxes paid (1980-2024)	\$215,736	\$202,965	\$12,771
Retirement benefits received (2025-2043)	222,865	219,094	<u>(3,771)</u>
Fiscal year taxpayer advantage			<u>\$ 9,000</u>

Net tax advantage to fiscal year taxpayer as a percentage of taxes paid by calendar year taxpayer is 4.2 percent (9,000 divided by 215,736).

^aSee notes on the following page.

Notes

1. SSA calculated initial retirement benefit amounts for these workers assuming retirement at age 65 in 2023 under the law prior to the Social Security Act Amendments of 1983. The amendments changed the retirement age to 66 years, 8 months, in 2025 for these workers. New benefit amounts were not calculated. Therefore, the initial benefit amounts reflected for both earners may be slightly understated. However, the relative difference in benefit amounts should remain about the same.
2. The benefit calculations made by SSA assumed that the self-employed workers had the same earnings from age 22 in 1980 through age 64 and used the Alternative II-B economic assumptions from the 1982 Trustees' Report. The fiscal year worker was assumed to have a tax year ending in June.
3. Retirement benefits (2025-2043) were calculated assuming an average life expectancy after retirement of 17.87 years for the primary beneficiary (data provided by SSA) and assuming benefit increases in years after 2025 are equal to the time value of money (i.e., discount rate) for those years.
4. Benefits are lower for the average wage earners reporting on a fiscal year basis because the final year of earnings represents a partial year for the benefit computation. Benefits are calculated using calendar years. Also, benefits are lower for the maximum earner reporting on a fiscal year basis due to the restrictions imposed by the contribution base in effect at the start of the fiscal year.
5. Taxes paid were calculated using the tax rates stipulated in the Social Security Act Amendments of 1983.
6. Using the average earner's taxes paid and retirement benefits received, and assuming the program maintains about 7,400 fiscal year workers each year, the trust fund will realize about an additional \$17.7 million over the fiscal year taxpayers' working and retirement lifetimes (about 63 years) if earnings credited to an individual's earnings record for a calendar year were taxed at the rate and up to the earnings ceiling in effect for that year. This represents the additional taxes that will be collected from fiscal year taxpayers less the additional benefits that will be paid them expressed in 1987 dollars.



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Mr. Philip A. Bernstein
Director, Human Resources
Division
United States General
Accounting Office
Washington, D.C. 20548

Dear Mr. Bernstein:

The Secretary asked that I respond to your request for our comments on your draft of a proposed report "Self-Employed Fiscal Year Taxpayers Can Receive an Advantage Compared to Self-Employed Calendar Year Taxpayers at the Social Security Trust Funds' Expense." The enclosed comments represent the tentative position of the Department and are subject to reevaluation when the final version of this report is received.

We appreciate the opportunity to comment on this draft report before its publication.

Sincerely yours,

Richard P. Kusserow
Inspector General

Enclosure

COMMENTS OF THE DEPARTMENT OF HEALTH AND HUMAN SERVICES ON THE
GAO DRAFT REPORT, "SELF-EMPLOYED FISCAL YEAR TAXPAYERS CAN
RECEIVE AN ADVANTAGE COMPARED TO SELF-EMPLOYED CALENDAR YEAR
TAXPAYERS AT THE SOCIAL SECURITY TRUST FUNDS' EXPENSE"

GAO Recommendation to the Congress

That the Social Security Act and Internal Revenue Code be amended so that earnings of fiscal year self-employed taxpayers are taxed at the rate and up to the earnings ceiling in effect for the year to which such earnings are credited to the individual's social security earnings record.

Department Comment

The recommendation is aimed at eliminating the present slight advantage in the law to fiscal year taxpayers which results because their total net earnings from self-employment are taxed and credited under the Social Security tax rate and contribution and benefit base in effect at the beginning of their tax year, even if the rate and base increase during the course of their tax year.

As GAO notes, the proposal would result in a very small saving to the Social Security trust funds. GAO estimates that about 7,400 self-employed individuals, out of a total of 7.6 million self-employed, report their earnings on a fiscal year basis--fewer than one in a thousand.

Changing the method of taxing and crediting fiscal year self-employment income would make the computation of Social Security self-employment tax liability even more complex for taxpayers and for the Social Security Administration than it is at present. The proposal would also impose additional burdens on the Social Security Administration's earnings systems, primarily due to the use of two different contribution and benefit bases for the same fiscal year earnings. It would require Social Security to determine the portion of the reporting year for which the old-year tax rate is applicable as well as the portion for which the new-year tax rate is applicable; presently the processes are designed to use only the old-year rate in the computation of tax liability.

Considering the very small savings to the trust funds, the increased complexity in the computation of the Social Security self-employment tax liability, and the present demands to upgrade and modernize the Social Security Administration's computer systems, we do not favor the recommended change in the law at this time.