



## Chapter 1

# How the Social Security System Operates

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### Learning objectives

- Recall that the Federal Insurance Contributions Act (FICA) tax applies to the funding of Social Security retirement, disability benefits, and Medicare benefits.
  - Recognize how the additional Medicare tax operates.
  - Identify instances in which there is no requirement for FICA taxation.
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### Overview

On August 14, 1935, the Social Security Act established a delivery system to provide old-age benefits for eligible workers, assistance for victims of industrial accidents, unemployment insurance benefits, and aid for dependent mothers and children, the blind, and the physically handicapped.

In 2016, the Social Security Administration (SSA) paid more than \$1 trillion to more than 62 million recipients; 75% were retired workers and their dependents, 16% were disabled workers and their dependents, and 9% were survivors of deceased workers.

The Social Security Act authorized the Social Security Board, which now operates as the Social Security Administration, to register citizens for benefits, administer the contributions received by the federal government, and send payments to recipients. U.S. Social Security “insurance” is supported from “contributions” in the form of taxes on individuals’ wages and employers’ payrolls rather than directly from government funds. Tax revenue generated from the income tax on Social Security benefits received

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by the IRS from individuals' personal income tax returns is also a source of funds to be paid to Social Security recipients.

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## A brief history of the Social Security Act

Before the 1930s, support for the elderly was generally the responsibility of the older individual's family rather than that of the federal government (except for veterans' pensions). However, in light of the economic nightmare caused by the Great Depression, congressional support for numerous proposals for a national old-age insurance system arose. On January 17, 1935, President Franklin D. Roosevelt sent a message to Congress asking for "economic security" legislation.

The same day, Senator Robert Wagner of New York and Representative David Lewis of Maryland introduced bills reflecting the Roosevelt administration's wishes. The resulting Senate and House bills encountered opposition from those who considered it a governmental takeover of individual choice and from those who sought exemption from payroll taxes for employers who adopted government-approved pension plans. Eventually the bill passed both houses, and on August 14, 1935, President Roosevelt signed the Social Security Act into law. Originally, the Social Security Act of 1935 was named the Economic Security Act, but this title was changed during a Ways and Means Committee meeting on March 1, 1935. Congressman Frank Buck (D-Calif.) made a motion to change the name of the bill to the "Social Security Act of 1935." The motion was carried by a voice vote of the committee.

Through the 80th anniversary of Social Security in the year 2015, the Social Security Act has had 12 major legislative changes. The changes have mostly added more workers subject to withholding of Social Security tax on wages, increased the age of eligibility, adjusted the amount of wages subject to Social Security withholding, and other changes meant to shore up what was a shortage of Social Security tax collections at various times in history.

The Bipartisan Budget Act of 2015 passed in November of 2015 rescinded two favorite methods of collecting Social Security benefits: the file and suspend and the restricted application for spousal benefits only at full retirement age (FRA). The two methods were first introduced in the Senior Citizens' Freedom to Work Act of 2000.

File and suspend was a strategy that allowed a worker to file for Social Security benefits at full retirement age and then immediately suspend receiving those benefits to a later age up to age 70. The filing part allowed a spouse or qualifying child to start receiving Social Security benefits on that worker's record even though the worker was delaying their own benefit. File and suspend is still allowed for those workers who were 66 by April 30, 2016. After that date, a spouse or qualifying child will only be allowed to collect a benefit on a worker's record if that worker is actually collecting a benefit. Suspension of benefit collection is still available, meaning that a Social Security recipient between the ages of 62 and 70 can suspend collection of benefits and get additional credits from that moment to age 70. However, as of April 30, 2016, spousal and dependent benefits of that worker are also suspended.

Restricted application is a strategy that became popular after being introduced in the Senior Citizens' Freedom to Work Act. It allowed a spouse at full retirement age to elect to collect only a spousal benefit on their spouse's work record and defer the collecting of his or her own benefit to age 70, collecting an 8% per year credit to their own benefit. People born in 1953 and earlier will still be allowed to file a restricted application. Those people born after 1953 will get the higher of their own benefit or the spousal benefit when they file for Social Security benefit no matter what age they file for the benefit. Therefore, restricted application is still available for those turning age 66 for the next two years.

Lump sum was also eliminated in the Bipartisan Budget Act. The lump sum allowed a person to file and suspend at full retirement age and then at a later age, before age 70, change their mind and collect a lump sum benefit for all of the benefits they would have started receiving at full retirement age to their current age, and also get a monthly benefit starting immediately as if they had begun collecting benefits from full retirement age. The lump sum is only allowed for people who were age 66 by April 30, 2016.

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## Knowledge check

1. Which began in 1935?
  - a. Social Security.
  - b. Medicaid.
  - c. SSI.
  - d. Medicare.

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## The Social Security Administration

In 1953, the SSA was placed under the Department of Health, Education, and Welfare, which became the Department of Health and Human Services in 1980. In 1994, President Bill Clinton signed 42 USC Section 901 returning the SSA to the status of an independent agency in the executive branch of government.

# FICA tax

Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) program and Medicare's Hospital Insurance (HI) program are financed primarily by employment taxes.

Social Security payroll taxes are collected under the authority of the FICA.

The payroll taxes collected for Social Security function as contributions to the social insurance system, commonly known as Social Security. Essentially, FICA operates as the tax provision of the Social Security Act as it appears in the IRC.

Individuals generally never stop paying Social Security and Medicare taxes on work or self-employment earnings, regardless of their age or whether they concurrently receive benefits. Employers continue to be responsible for the matching portion of Social Security and Medicare taxes.

Tax rates are set by law (see Compilation of Social Security Laws at [https://www.ssa.gov/OP\\_Home/comp2/F083-591.html](https://www.ssa.gov/OP_Home/comp2/F083-591.html)) and apply to earnings up to a maximum amount (<https://www.ssa.gov/OACT/COLA/cbb.html#Series>) for OASDI (<https://www.ssa.gov/OACT/ProgData/taxRates.html>).

FICA tax includes two separate taxes. One is Social Security tax and the other is Medicare tax. Different rates apply for each of these taxes.

The current tax rate for Social Security is 6.2% for the employer and 6.2% for the employee, or 12.4% total. The current rate for Medicare is 1.45% for the employer and 1.45% for the employee, or 2.9% total.

Only the Social Security tax has a wage base limit. The wage base limit is the maximum wage that is subject to the tax for that year. For earnings in 2019, this base is \$132,900.

There is no wage base limit for Medicare tax. All covered wages are subject to Medicare tax.

Base rates for FICA and Medicare tax rates have not changed and a 0.9% Medicare tax on earned income applies to certain upper-income taxpayers.

## **FICA and Medicare tax rates**

In tax year 2019, the rate is 7.65% in total: 6.2% for the Social Security portion and 1.45% for Medicare.

Beginning January 1, 2013, Additional Medicare Tax applies to an individual's Medicare wages that exceed a threshold amount, based on the taxpayer's filing status. Employers are responsible for withholding the 0.9% Additional Medicare Tax on earned income in excess of \$200,000 in a calendar year, without regard to filing status. An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of \$200,000 to an employee and continue to withhold it each pay period until the end of the calendar year. There is no employer match for Additional Medicare Tax.

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## The taxable wage base

For 2019, the first \$132,900 of wages is taxed at 6.2 percent for the non-Medicare element of Social Security. Earnings greater than this amount are taxed for Medicare purposes but not in terms of Social Security retirement, survivor, or disability insurance benefits. Therefore, an employee's maximum Social Security contribution for 2019 is \$8,638.50 and for 2018 was \$7,979.40 overpayment of Social Security taxes.

Taxpayers who work for more than one employer in any tax year and have earnings in excess of \$132,900 in 2019 and \$128,700 in 2018 may have paid too much Social Security tax. Keep in mind that when an individual works more than one job in a calendar year, each employer is required to withhold Social Security taxes on wages up to the taxable wage base.

Therefore, a taxpayer may wind up exceeding the maximum Social Security contribution limit. Individuals can claim a tax credit for this overpayment on Form 1040 when they file their personal income tax returns. The excess Social Security tax is shown as an additional payment in the payment section of Form 1040 on page 2.

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## Knowledge check

2. What does the taxable wage base operate to limit?
  - a. The Medicare portion of FICA tax.
  - b. The OASDI portion of FICA tax.
  - c. Both the OASDI and Medicare portions of FICA tax.
  - d. Discrimination in FICA taxation.

# Medicare tax

Medicare is taxed at 1.45% of wages, and, unlike the retirement and disability portions of FICA tax, there is no wage base limit. Employers are also required to match this contribution, bringing the total funding to 2.9% of all wages earned.

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## Employer reporting and responsibilities

The 15.3% FICA tax is broken down as follows:

- Social Security (employee pays 6.2%)
- Social Security (employer pays 6.2%)
- Medicare (employee pays 1.45%)
- Medicare (employer pays 1.45%)

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## Factoring the FICA tax

The employer's portion of FICA tax is the same amount required to be withheld from employee wages. Different rules apply for employees who receive tips.

In other words, a company withholds 6.2% Social Security tax from employee wages and pays an additional 6.2% as the employer share of the tax (6.2 employee portion + 6.2 employer portion = 12.4% total). Additionally, the employer must withhold a 1.45% Medicare tax from employee wages and pay an additional 1.45% as the employer portion (1.45 employee portion + 1.45 employer portion = 2.9% total).



### Example 1-1

In 2019, Beauteous Boots, Inc. has one employee, Sam Stockwell, to whom it pays gross wages of \$1,000 every two weeks. Beauteous Boots will be required to withhold from each of Sam's paychecks \$62 in Social Security taxes ( $\$1,000 \times 6.2\%$ ) and \$14.50 in Medicare taxes ( $\$1,000 \times 1.45\%$ ).

Beauteous Boots, Inc. will also owe equal amounts (\$62 in Social Security and \$14.50 in Medicare) as the employer's portion of those taxes. In other words, each \$1,000 wage payment will create a combined FICA tax liability of \$153.

Because the total wages that Beauteous Boots, Inc., pays Sam for the calendar year do not exceed \$200,000, it does not have to withhold the 0.9% Medicare surtax from Sam's wages.

# Medicare tax on earned income

As of 2013, and ostensibly for the foreseeable future, high-income households will pay more into Medicare as a result of the health care reform law, known as the Patient Protection and Affordable Care Act (ACA) or, more colloquially, “Obamacare.”

The Medicare payroll tax, which, unlike the retirement portion of FICA tax, applies to unlimited amounts of earned income, has increased for individuals making more than \$200,000 in wages, and joint filers making more than \$250,000.

The current 2.9% Medicare tax on wages is payable one-half by the employer and one-half by the employee. The ACA does not change the employer portion. Instead, the new 0.9% Medicare tax will be payable solely by the employee and is levied in addition to the current Medicare payroll tax.

Under the new law, which became effective in 2013, high-income individuals pay another 0.9 percentage point, so their share will total 2.35% of their wages.

Note that the tax applies to earned income more than the income thresholds, rather than to adjusted gross income (AGI).



## Example 1-2

As of November 30, 2019, Pam Peterson received \$170,000 in wages from Acme Associates, Inc. On December 1, 2019, Acme paid Pam a \$50,000 bonus. Prior to December 1, Acme was not required to withhold the Medicare tax surcharge. On December 1, Acme is required to withhold additional Medicare Tax on \$20,000 of the \$50,000 bonus. However, Acme may not withhold additional Medicare Tax on the other \$30,000. It must also withhold the additional 0.9% Medicare tax on any other wages paid to Pam in December 2019.

In this example, the employer must begin withholding the surtax in the pay period in which it pays wages in excess of the \$200,000 (assuming single filing status) “floor” to Pam and it must continue to withhold it each pay period until the end of the calendar year.

Keep in mind that the following thresholds of wages (and not AGI) trigger the tax:

Filing status	Threshold amount
Married filing jointly—combined income	\$250,000
Married filing separately	\$125,000
Single, head of household, qualifying widow or widower	\$200,000

The 0.9% Medicare surtax applies to wages, compensation, and self-employment earnings greater than a threshold amount that is based on the employee’s filing status. Once the threshold is reached, the tax

applies to all wages that are currently subject to Medicare tax, the Railroad Retirement Tax Act, or the Self-Employment Compensation Act.

An employer must withhold Additional Medicare Tax from wages it pays to an individual in excess of \$200,000 in a calendar year, without regard to the individual's filing status or wages paid by another employer. An individual may owe more than the amount withheld by the employer, depending on the individual's filing status, wages, compensation, and self-employment income. In that case, the individual should make estimated tax payments and request additional income tax withholding using Form W-4, *Employee's Withholding Allowance Certificate*.

The value of taxable wages not paid in cash, such as noncash fringe benefits, are subject to Additional Medicare Tax, if, in combination with other wages, they exceed the individual's applicable threshold.

It is interesting to note that this rule applies even if both spouses work for the same company.



### Example 1-3

Arthur Carson, an employee of Fantastic Fabrications, Inc., earns \$220,000 during 2019. He is married to Alice Carson, but she is a full-time homemaker and mother with no earned income. Fantastic Fabrications, Inc. must start withholding the additional 0.9% Medicare tax when Arthur's earnings exceed \$200,000. Arthur's income will be over-withheld because the couple's combined income is beneath the married, filing jointly threshold of \$250,000.

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## Employers only know their own payrolls

As a practical matter, in most real-life situations, the employer would have little, if any, opportunity to learn the earned income of the employer's spouse or that provided by an unrelated employer.



### Example 1-4

Employee Lois Palmer earns \$130,000 during 2019. In the same year, Lois' husband Edward earns \$100,000 from one employer in his day job and \$60,000 from another employer performing his night job. The Palmers' combined earnings are \$290,000, clearly \$40,000 more than the married, filing jointly threshold. However, none of their employers are required to withhold the 0.9% surtax because neither Lois nor Edward earned more than \$200,000 from any one employer.

Taxpayer-employees having concerns about being under-withheld for the Medicare surtax can make estimated payments or they can request additional income tax withholding on Form W-4. The employee can then apply the additional income tax withheld against the Medicare surtax liability on Form 1040.

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## Employees earning tips

The employer is responsible for taxes on reported tips, and for paying the employer's portion of FICA and Federal Unemployment Tax Act taxes on them. This can be challenging because the employer has no control over the amount of tips their employees receive.

The employer must also withhold for the 0.9% FICA Medicare surtax. Tips are subject to FICA Medicare surtax withholding if, in combination with other wages paid by the employer, they exceed the \$200,000 withholding threshold.

However, any employer's obligation to withhold the employee's portion of FICA (and income taxes) is limited to the amount of employee funds under that employer's control. That describes the nontip wages that the employer would otherwise pay to the employee.

If insufficient funds are available, they should be applied to the taxes in the following order:

- First, to the employee's portion of the FICA tax due on the nontip wage payments
- Next, to the employer's portion of the FICA tax due on the nontip wage payments
- Next, to the employee's portion of the FICA tax due on the tip income
- Last, to the employer's portion of the FICA tax due on the tip income

Tips represent payments that customers make without being obligated to do so. Customers should have the unrestricted right to determine the amount of their tips. If the amount is dictated by the employer's policy, the tips may be classified as service charges.

An employee's cash tips are not treated as taxable wages unless they amount to \$20 or more in a calendar month, and the employee reports them to the employer by the 10th of the month following the month in which they were received. Once the \$20 threshold has been reached, all cash tips are subject to FICA tax, including the initial \$20.

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## No above-the-line deduction for self-employed

Further, because self-employed individuals may currently deduct one-half of the self-employment tax imposed on them, unfortunately, those self-employed individuals will not be permitted to deduct any portion of this 0.9% additional Medicare tax.

# Medicare tax on net investment income

Since January 1, 2013, the Healthcare and Education Reconciliation Act of 2010 that clarified the ACA applied a 3.8% Medicare tax to unearned income for certain high-income individuals. Specifically, the 3.8% tax applies to the lesser of (1) an individual's "net investment income" and (2) the excess of the individual's modified AGI more than \$200,000 (\$250,000 applicable to a joint return).

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## Knowledge check

3. Which would be considered in determining the amount of unearned income to which the 3.8% tax on unearned income applies?
  - a. IRA distributions.
  - b. Form 1099 income from part-time employment.
  - c. Long-term capital gain.
  - d. Gains on home sales not exceeding \$250,000 or \$500,000 (on a joint return).

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## What is net investment income?

In general, investment income includes, but is not limited to, interest, dividends, capital gains (regardless of how long the asset had been held), rental and royalty income, nonqualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer (within the meaning of IRC Section 469). To calculate a taxpayer's net investment income, the investment income is reduced by certain expenses that would be properly allocable to the income.

To the extent that gains are not otherwise offset by capital losses, the following (net) gains are common examples of items taken into account in computing net investment income:

- Gains from the sale of stocks, bonds, and mutual funds
- Capital gain distributions from mutual funds
- Gains from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence)
- Gains from the sale of interests in partnerships and S corporations (to the extent of passive ownership)

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## What is not considered investment income?

The following sources of income are not classified as investment income:

- Wages
- Unemployment compensation
- Operating income from a nonpassive business

- Social Security benefits
- Alimony
- Tax-exempt interest
- Self-employment income
- Alaska permanent fund dividends
- Distributions from certain qualified plans

### What about gains from the sale of a primary residence?

As we might expect, to the extent that gains on home sales are excluded under IRC Section 121, such gains are not classified as net investment income. However, any gain that does not qualify for the exclusion or to the extent it exceeds the exclusion amount (generally \$500,000 for joint filers and \$250,000 for those using single filing status) such gains would be subject to the tax. The following examples show how.



#### Example 1-5

Alan Archer, a single filer, earns \$210,000 in wages and sells his principal residence, which he has owned and resided in for the last 10 years, for \$420,000. Alan's cost basis in the home is \$200,000. Alan's realized gain on the sale is \$220,000. Fortunately, under IRC Section 121, Alan may exclude up to \$250,000 of gain on the sale. Because this gain is excluded for regular income tax purposes, it is also excluded for purposes of determining net investment income. In this example, the net investment income tax (NIIT) does not apply to the gain from the sale of Alan's home.



#### Example 1-6

Bonnie and Clyde Parker, a married couple filing jointly, sell their principal residence, which they have owned and resided in for the last 10 years, for \$1.3 million. Bonnie and Clyde's cost basis in the home is \$700,000. Bonnie and Clyde's realized gain on the sale is \$600,000. The recognized gain subject to regular income taxes is \$100,000 (\$600,000 realized gain less the \$500,000 IRC Section 121 exclusion).

Bonnie and Clyde have \$125,000 of other net investment income, which brings their total net investment income to \$225,000. The Parkers' modified adjusted gross income is \$300,000 and exceeds the threshold amount of \$250,000 by \$50,000.

Bonnie and Clyde are subject to NIIT on the lesser of \$225,000 (total net investment income) or \$50,000 (the amount by which Bonnie and Clyde's modified adjusted gross income exceeds the \$250,000 married filing jointly threshold). Therefore, the Parkers owe NIIT of \$1,900 ( $\$50,000 \times 3.8\%$ ).



### Example 1-7

Daniel Dawkins, a single filer, earns \$45,000 in wages and sells his principal residence, which he has owned and resided in for the last 10 years, for \$1 million. Daniel's cost basis in the home is \$600,000. Dan's realized gain on the sale is \$400,000. The recognized gain subject to regular income taxes is \$150,000 (\$400,000 realized gain less the \$250,000 IRC Section 121 exclusion), which is also net investment income. Daniel's modified adjusted gross income is \$195,000. Because Dan's modified adjusted gross income is less than the threshold amount of \$200,000, he does not owe any NIIT.

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## When AGI is entirely investment income

When the taxpayer's income is entirely classified as net investment income, it is still possible that not all of it will be subject to the tax, as the following example illustrates:



### Example 1-8

Edith Shilton, a single filer, inherited a fortune from her uncle, the founder of a successful hotel chain, and, therefore, did not work. Edith earned only investment income from a substantial stock and bond portfolio. In 2019, the portfolio (none of which would be considered qualified retirement assets for federal income tax purposes) produces \$2 million in net investment income. This amount also represents Edith's modified adjusted income for that tax year. The amount of Medicare contribution tax to which Edith would be liable is calculated by multiplying 3.8% to the lesser of

1. the net investment income of \$2 million, or
2. the \$2 million reduced by the \$200,000 threshold amount for a single taxpayer.

Therefore, Edith will incur a Medicare contribution tax of \$68,400, which is calculated by applying the 3.8% tax to \$1,800,000 (\$2 million in net unearned income reduced by the \$200,000 single taxpayer threshold).

# Not everyone is covered under Social Security

When the Social Security program began, certain groups of workers were already covered under other retirement plans. Railroad workers were covered under the Railroad Retirement Board. Workers covered under the Railroad Retirement program do not fund or receive retirement benefits from Social Security, but they may buy into Medicare. Federal government employees (including members of Congress) were covered by the Civil Service Retirement System. Those who have been continuously employed by the federal government starting before 1984 do not fund or receive retirement benefits from Social Security. Today, members of Congress pay into the system.

Employees whose services are not covered for Social Security, but who are required to pay the Medicare-only portion of FICA, are referred to as Medicare Qualified Government Employees.

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## The clergy and Social Security

Before 1968, a member of the clergy had to participate in Social Security. Today, most ordained, commissioned, or licensed ministers, rabbis, and other members of religious orders still pay FICA taxes for Social Security and Medicare coverage (often under self-employment tax provisions) for the services performed in a religious capacity unless that individual requested and received a tax exemption from self-employment tax. This is true whether the clergyperson is an employee of a religious organization or a self-employed person under the common law rules.

However, since 1951, an ordained member of the clergy (including members of religious orders) may object to participating in Social Security benefits based upon conscientious or religious grounds. To object, the clergyperson must file Form 4361. The individual must disclose his or her specific grounds for opting out. This election applies only to the income received in conjunction with vocational ministry. The minister may opt out relative to ministry salary and extra self-employment income earned through pastoral duties, such as honorariums for weddings and funerals. Before 1968, a member of the clergy had to elect to be covered by Social Security.

The form must be filed before the due date of the individual's personal tax return for the second taxable year in which the individual earned \$400 or more from work as a member of the clergy. The election is irrevocable. The ordained clergyperson can be treated as self-employed for FICA but may be considered an employee for other tax purposes.

Self-employment tax does not apply to any postretirement benefits or the rental value of any parsonage or parsonage allowance granted to the clergyperson. The clergyperson who opts out will not be entitled to Social Security or Medicare benefits based on ministerial income.

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## Parents employing children

Parents employing children under age 18 working for them in unincorporated businesses are not required to withhold or match FICA tax.

For example, Natalie Sanchez owns a small public relations firm. She is a Schedule C taxpayer. She employs her son, Nathan, \$10 per hour to input data into her computer, file, and help maintain an orderly office. In 2019, she pays Nathan \$4,800. Natalie is not required to withhold FICA tax on Nathan's wages.

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## Other exceptions

Members of Native American tribal councils and students employed by the colleges they are attending are not required to pay FICA taxes on their earned income. Members of the armed services do participate in Social Security through FICA tax in the same manner as most other workers.

# Summary

Our Social Security system provides retirement, disability, and survivor benefits to tens of millions of Americans. Most benefits are funded through FICA taxes, shared by workers and their employers, although newer Medicare taxes apply to workers alone. With few exceptions, earned income such as wages, tips, commissions, and more are subject to FICA tax. FICA tax itself falls into two categories—the OASDI (generally, retirement) portion and the Medicare portion. FICA tax on the OASDI portion applies only on wages up to an annually indexed taxable wage base. In contrast, the Medicare portion of FICA tax generally applies to all income.

