Optional Social Security

Abstract:
Farmers that have sustained losses in their farming operation may not have made adequate contributions to be eligible for Social Security disability coverage. Farmers with losses are eligible to use the optional method for self-employment tax. This section discusses the filing process and explains some of the incentives for doing so.

ISSUE 3: OPTIONAL METHOD FOR SELF-EMPLOYMENT TAX

The farm optional method under I.R.C. §1402(a) allows farmers to pay self-employment (SE) tax on two-thirds of gross farm income, if gross farm income is not more than $2,400.

Example 1. Ima Peach has $2,100 of gross farm income in 2001. Her net farm income is ($1,000). The regular method of computing self-employment tax results in no SE tax liability. Ima can elect to report $1,400 (two-thirds of $2,100) as her self-employment income. She will owe $214 ($1,400 .153) of self-employment tax on that income.

The farm optional method also allows farmers to pay self-employment tax on $1,600 of income if gross income is greater than $2,400 and net earnings from farm self-employment is less than $1,733.

Example 2. Ima Peach from Example 1 had $2,500 of gross farm income in 2001 and her net farm income was $1,000. The regular method of computing self-employment tax results in $141 ($1,000 .9235 .153) of SE tax liability. Ima can elect to report $1,600 as her self-employment income. She will owe $245 ($1,600 .153) of self-employment tax on that income.

Incentive for the Election

The incentive to pay self-employment taxes when none would otherwise be due is to meet the qualifications for social security benefits.

To be eligible for disability benefits from social security, a farmer who is age 31 or older must be fully insured (40 quarters of coverage) or currently insured (20 quarters of coverage in the 10 years or 40 quarters immediately before death or disability). Before 1985, the deemed $1,600 of income under the farm optional method resulted in four quarters of coverage. In 1985, the amount needed for a quarter of social security coverage increased to $410; thus paying on the deemed $1,600 of income under the farm optional method provided the farmer only three quarters of coverage. In 1991, the amount needed for a quarter of coverage increased to $540; thus the deemed $1,600 of income under the farm optional method yielded only two quarters of coverage. In 2001, a quarter of coverage increased to $830; thus only one quarter of coverage is obtained from the deemed $1,600 of income under the farm optional method. Since the deemed

$1,600 of income under the farm optional method has not changed since 1956, farmers are increasingly at risk of not being eligible for social security disability benefits.

> **Observation.** Another incentive for using the optional method is to increase income for purposes of the earned income credit.

Example 3. John and Mary Farmer were married and started a farming operation in 1991. John was born on July 14, 1969; thus he was 22 years old when he began farming in 1991. Son John Jr. was born in 1994 and daughter Marie was born in 1996. John used aggressive tax planning in 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 1998 through 2001 are shown below:

Year	Gross Farm Income	Net Farm Profit or (Loss)
1998	$25,158	$(8,968)
1999	37,289	(5,662)
2000	28,305	(7,421)
2001	64,222	3,400

John did not elect the farm optional method for the years 1991–1999 and received no quarters of social security coverage. On December 14, 2001, John was killed in an automobile accident.

Question 1. Are Mary and her children eligible for social security survivor's benefits based on John's record?

Answer 1. For Mary and her children to be eligible for survivor's benefits, John must have been either fully insured or currently insured when he died.

To be fully insured, John must have had the lesser of:

1. 40 quarters of coverage (the general rule), or
2. 10 quarters of coverage (one quarter for each year after age 21 (not counting the year of death), with a minimum of six quarters of coverage)

To be currently insured, John must have credit for having worked 20 quarters (that is, the number of quarters required for workers age 31 through 42).

John earned four quarters of coverage in 2001 with his $3,400 of net farm profit ($3,400/$830 is more than 4). Therefore, based on the returns he has filed, he was neither fully nor currently insured on the day he died.

Question 2. Is there anything Mary can do to receive benefits?

Answer 2. Yes. Mary can elect the farm optional method of paying self-employment tax on timely filed amended returns. If she amends John's returns for 1997 through 1999 and elects the optional method, John will be treated as having $1,600 of earned income in each of those three years, which will give him two quarters of coverage for each of those years.

1998:	$1,600 / $700 = 2.289
1999:	$1,600 / $740 = 2.16
2000:	$1,600 / $780 = 2.05

Those additional six quarters of coverage give John a total of 10 quarters of coverage, which makes him fully insured at the time he died. Consequently, Mary and her children qualify for survivor's benefits.

Practitioner Note. If John had a farm loss in 2001 and died in 2002, the amendment of his previous three year's returns (1999, 2000, and 2001) would result in only five additional quarters of coverage because the optional method for 2001 would give him only one quarter of coverage.