JOINT COMMITTEE ON TAXATION
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TESTIMONY OF GEORGE K. YIN CHIEF OF STAFF OF THE JOINT COMMITTEE ON TAXATION

AT A HEARING OF THE SENATE COMMITTEE ON FINANCE ON "SOCIAL SECURITY: ACHIEVING SUSTAINABLE SOLVENCY"

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Mr. Chairman, Senator Baucus, members of the Committee, thank you for inviting me to testify today. I have been asked to present to the Committee various tax legislative changes that might be adopted to improve the solvency of the Social Security system. After a brief summary of current law, I will describe possible changes to the employment tax base and certain options relating to the employment tax rate and cap. I have included in my testimony very preliminary revenue estimates of most of the options presented, assuming they are implemented in 2006 with no transitional relief or phase-in. These estimates reflect the most recent baseline provided by the Congressional Budget Office ("CBO") and, with respect to options to expand the employment tax base, include outlay effects associated with the impact of the proposals on Social Security and Medicare benefits as provided to the Joint Committee staff by CBO.

Summary of Current Law

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA"). A similar tax is imposed on the net earnings from self-employment under the Self-Employment Contributions Act ("SECA").

The FICA tax consists of two parts: (1) old-age, survivor and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($90,000 for 2005) (the "tax cap"). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

Similarly, the SECA tax has two components. Under the OASDI component, the rate of tax is the combined employer and employee rates under the OASDI portion of FICA (12.4 percent). Under the HI component, the rate is the combined employer and employee rates under the HI portion of FICA (2.9 percent). The OASDI portion of SECA tax is subject to the same limit as under FICA, i.e., this component is capped at $90,000 of self-employment income (for 2005). The amount of self-employment income subject to HI taxes is not capped.

For SECA tax purposes, net earnings from self-employment generally include gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gain or loss from the sale or exchange of a capital asset, from timber and certain mineral property, or from other property that is neither inventory nor held primarily for sale to customers.

Possible Changes to the Employment Tax Base

Before considering possible employment tax rate changes or an increase to the employment tax cap, the Committee should examine areas in which the employment tax base is not comprehensive. Distortions created by exceptions to the base may be exacerbated if they are permitted to continue with an increase in tax rates or the tax cap. Set forth below are a number of possible ways to improve the comprehensiveness of the employment tax base. Almost all of these options were included in the recent Joint Committee staff report on "*Options to Improve Tax Compliance and Reform Tax Expenditures*."[1] As you know, this report was prepared in response to a request from the Chairman and Ranking Member. A detailed description and analysis of these options may be found in the published report.

1. Modify Determination of Amounts Subject to Employment Tax for Partners and S Corporation Shareholders

Present law provides different employment tax treatment of individuals who are owners of interests in passthrough entities and perform services in the business. S corporation shareholder-employees are treated like other employees, and therefore their wages from the corporation are subject to FICA tax. In contrast, a broader category of income of general partners, that is, the partners' distributive share (whether or not distributed) of income from any trade or business carried on by the partnership, is subject to SECA tax. The distributive share of income of limited partners is generally not subject to employment tax, and the employment tax

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[1] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005. The report proposes a number of options relating to FICA and SECA taxes. The proposals relating to FICA may have the effect of increasing FICA taxes imposed on some employers and employees. Likewise, the proposals relating to SECA taxes may have the effect of increasing SECA taxes for some individuals. In the case of individuals whose earnings equal or exceed the OASDI taxable wage base without regard to a proposal, only HI tax will apply to the additional earnings that result under the proposal. The FICA and SECA proposals will result in increasing revenues for the Social Security and Medicare programs. In addition, requiring additional amounts to be subject to FICA and SECA taxes may increase benefits for some individuals, as well as long-term costs under such programs.

treatment of partners who are neither limited nor general partners is uncertain. These differences may cause a taxpayer's choice of business form to be motivated by a desire to avoid or reduce employment tax, rather than by nontax considerations.

Certain of these distinctions arise as a result of outdated State law concepts. For example, because State law historically prohibited limited partners from performing services for their partnerships, their share of partnership income, except for guaranteed payments received by the partner for services rendered, was not made subject to SECA tax. Many State laws no longer have this limitation. In addition, there is much uncertainty caused by the widespread use of limited liability companies ("LLCs"), which are generally treated like partnerships for Federal tax purposes. Some LLC owners may view themselves as comparable to limited partners for employment tax purposes and some may take the position that neither SECA nor FICA tax applies.

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to employment tax on the shareholder's distributive share of income. It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their employment taxes. S corporation shareholders may pay themselves wages below the tax cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders.[2] They may take the position that no part of their S corporation distributive share is subject to employment tax. While present law provides that the entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis.

Under the proposal in the Joint Committee staff report, the present-law rule for general partners generally applies to any owner of a partnership or S corporation (including a general or limited partner, an owner of an LLC treated as a partnership for Federal tax purposes, and a shareholder of an S corporation) for SECA tax purposes. Thus, all such owners are generally subject to SECA tax on their distributive shares (whether or not distributed) of the entity's income. As under present law, specified types of income are excluded from SECA tax, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service entity, all of the owner's net income from the entity is treated as net earnings from self-employment.[3] If any owner does not materially participate in the trade or business of the entity, a special rule provides that only the owner's reasonable compensation from the entity is treated as subject to SECA tax. Thus, some general partners who are subject to

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[2] Because the HI component of the FICA and SECA taxes has no wage cap, this approach may be viewed as a tax planning opportunity with respect to HI tax even at higher wage levels.

[3] A service entity is an entity, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to Internal Revenue Code sec. 448(d)(2)).

SECA tax on their distributive shares of partnership income under present law will be subject to SECA tax only on reasonable compensation from the partnership under the proposal.

The conceptual premise of the proposal is that the base for FICA and SECA taxes is labor income. The proposal applies this notion more uniformly than does present law to individuals who perform services for or on behalf of a passthrough entity in which they own an interest (i.e., a partnership, limited liability company, or S corporation). The proposal treats such individuals similarly to sole proprietors, as well as similarly to each other. Not only does this more uniform treatment improve the fairness of the tax law and increase the internal consistency of the tax rules, it also tends to improve tax neutrality by reducing the importance of FICA and SECA tax differences in taxpayers' choice of business entity.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $36.3 billion, increase off-budget revenues by $28.2 billion, and increase outlays by $0.5 billion, for a net increase in revenues of $64 billion overall.

2. Impose Withholding on Certain Payments Made by Government Entities

IRS studies have consistently shown that the underreporting of compensation income by sole proprietors and others not subject to wage withholding is the single largest contributor to the tax gap. To address this problem, the Joint Committee staff report includes a proposal to impose withholding on certain government payments for goods and services that are not currently subject to withholding. Because such payments represent a significant part of the economy, the proposal can be expected to improve compliance to a significant extent without burdening any private sector payors. The proposal thus attempts to balance the goals of improving compliance and not creating undue administrative burdens. The proposal exempts smaller governmental entities from the withholding requirement.

This proposal can be expected to increase income tax and employment tax revenues, both by collecting some tax from the transaction and by stimulating voluntary reporting and payment of tax apart from any amounts actually withheld. Other proposals in this area have been suggested which would impose withholding in additional situations. For example, the National Taxpayer Advocate has proposed imposing withholding on all payments to nonemployees.[4] Proposals that increase withholding could generally be expected to have additional positive impact on both income and employment taxes.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $6.4 billion.[5]

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[4] National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004), at 484. The proposal is discussed in detail in National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003) at 256-269.

[5] At present, the estimate for this proposal does not separately identify the income tax effect from possible FICA or SECA effects and does not incorporate the most recent CBO baseline.

3. Provide Consistent FICA Treatment of Salary Reduction Amounts

Under present law, certain retirement and other employee benefits may be provided through salary reduction contributions by employees. Present law provides inconsistent treatment of such salary reduction amounts for FICA purposes. Contributions made to tax-favored retirement plans by salary reduction, such as contributions to 401(k) plans (including the Federal Thrift Savings Plan), are wages for FICA purposes. However, salary reduction amounts used to provide other benefits are excluded from wages for FICA purposes. The types of nonretirement benefits that may be provided on a salary reduction basis include health coverage (insurance as well as reimbursement of expenses not covered by insurance), dependent care assistance, certain group-term life insurance, and qualified parking, van pooling and transit benefits.

Legislative history indicates that salary reduction retirement contributions are included in the FICA tax base in order to avoid undermining that base and making the Social Security system partially elective. This rationale for the FICA treatment of retirement plan contributions made by salary reduction applies equally to salary reduction amounts used to provide other benefits.

The Joint Committee staff report proposes providing consistent treatment of salary reduction amounts for FICA purposes. One effect of the proposal is to provide more consistent FICA treatment of amounts paid by employees to purchase benefits, regardless of whether the benefits are provided through an employer-sponsored plan. For example, under present law, an employee who cannot purchase health insurance through his or her employer must pay FICA tax on his or her salary, including any amounts used to purchase individual health insurance coverage. Under the proposal, similar FICA treatment applies to salary reduction amounts used to purchase health insurance coverage on a salary reduction basis.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $42.4 billion, increase off-budget revenues by $182.9 billion, and increase outlays by $2.6 billion, for a net increase in revenues of $222.7 billion overall.

4. Conform Calculation of FICA Taxes and SECA Taxes

The Social Security Act amendments of 1983 were intended to place SECA taxes on the same economic footing as FICA taxes. This involved equalizing the FICA and SECA tax rates for the first time. At the same time, self-employed taxpayers were allowed a deduction from self-employment earnings in recognition of the fact that such earnings include the "employer share" of SECA taxes, whereas FICA tax rates apply to wages exclusive of the employer share of FICA tax. However, due to a mathematical inconsistency in the calculation of the deduction for SECA purposes, self-employment income is taxed more favorably than wages. The Joint Committee staff proposal modifies the formula for calculating the deduction from self-employment earnings to make SECA taxes economically equivalent to FICA taxes. Under the proposal, the dollar amount of the deduction from self-employment earnings is equal to one-half of SECA taxes owed.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $3 billion, increase off-budget revenues by $1.6 billion, and increase outlays by less than $50 million, for a net increase in revenues of $4.6 billion overall.

5. Modify FICA Tax Exception for Students

Under present law, FICA taxes do not apply to services performed by a student who is enrolled and regularly attending classes at a school, college, or university. Legislative history provides that this exception (referred to as the "student exception") is intended to apply to situations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, the payment of tax is inconsequential and a nuisance, and the related benefit rights are also inconsequential. However, the student exception has been viewed by certain taxpayers as applying more broadly to include situations that are similar to full-time employment.

The scope of the student exception has been the subject of uncertainty in recent years, particularly with respect to its application to medical residents. In two cases, courts have held that the student exception applies to medical residents performing services at a hospital or other medical facility, whereas another court has held that medical residents are not students for purposes of the exception. Uncertainty as to the proper scope of the student exception results in part from a lack of clear standards for applying the exception.

The IRS issued final regulations in December 2004 relating to the terms "school, college or university" and "student" for purposes of the student exception. Although these regulations help to clarify the scope of the student exception, clear statutory standards would make the exception more administrable. The Joint Committee staff report proposes codifying the IRS regulations that clarify the scope of the present-law student exception. In addition, the report proposes amending the student exception so that it does not apply to individuals whose earnings subject to the exception exceed an annual dollar limit. The original intent of the exception can be implemented more effectively through such a dollar limit.

Under the proposal, the student exception applies to an individual for a year only if the individual's earnings from the school, college, or university are less than the amount needed to receive a quarter of FICA coverage for the year ($920 for 2005). Thus, if an individual's earnings exceed the limit, the individual's earnings are subject to FICA, regardless of whether the individual otherwise meets the requirements for the student exception. If the limit is exceeded, all of the individual's earnings are subject to FICA, including earnings up to the limit, thus enabling the individual to receive at least one quarter of coverage for the year.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $0.5 billion, increase off-budget revenues by $3.0 billion, and increase outlays by less than $50 million, for a net increase in revenues of $3.5 billion overall.

6. Apply Employment Taxes to Sales Incentive Payments Made by Manufacturers

Under current IRS guidance, commissions or other sales incentive payments paid by a manufacturer or distributor to sales people employed by a dealer are includible in gross income, but are not subject to FICA or SECA taxes. The basis for this position with respect to FICA taxes is that the sales incentive payments are not wages because the sales people are not employees of the manufacturer or distributor.[6] Further, because the sales people are employees of a dealer, they are not self-employed and therefore not subject to SECA taxes. In contrast, in other circumstances, under present law, amounts received for services performed by an employee from a person other than the employer are generally treated as wages to the same extent as amounts received from the employer. Although services performed by sales people who are the employees of a dealer benefit the manufacturers and distributors of the products sold, treating sales incentive payments as compensation for services for the manufacturer or distributor creates an artificial standard that causes inconsistent employment tax results. In effect, by structuring compensation as payments from a manufacturer or distributor, the parties can determine among themselves to what extent compensation will be subject to employment taxes. This undermines the employment tax base. Sales incentive payments are compensation for services and, therefore, should be subject to either FICA or SECA taxes.

The Joint Committee staff report proposes that sales incentives payments made by manufacturers or distributors to sales people employed by dealers are wages for FICA tax purposes, regardless of whether an employment relationship exists between the sales people and the manufacturers or distributors.[7]

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $0.1 billion, increase off-budget revenues by $0.4 billion, and increase outlays by less than $50 million, for a net increase in revenues of $0.5 billion overall.

7. Extend Medicare Payroll Tax to All State and Local Government Employees

Most workers pay HI taxes during their entire working lives. However, State and local government workers are not covered by Medicare or subject to the HI tax if they were hired before March 31, 1986, and they are not covered by a voluntary agreement and are covered by a retirement plan. Even though not subject to the HI tax with respect to such employment, many State and local government workers receive the same Medicare coverage as other workers, either through other employment or spousal coverage.

The Joint Committee staff report proposes extending Medicare coverage on a mandatory basis to all employees of State and local governments, without regard to their dates of hire or participation in a retirement system. Such employees and their employers would become liable for the HI tax and the employees would earn credit toward Medicare eligibility based on their covered earnings. Expanding the HI tax to all State and local government workers would increase the equity of the payroll tax system. Extending the hospital insurance tax to all State and local employees places such employees in a comparable position to most other workers.

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[6] Under current IRS guidance, sales incentive payments are also not subject to income tax withholding.

[7] The proposal also subjects such payments to income tax withholding.

Over the period 2006-2015, this option is estimated to increase on-budget revenues by $4.9 billion and increase outlays by less than $50 million, for a net increase in revenues of $4.9 billion overall.

8. Additional Proposals

The Joint Committee staff report contains other proposals that, while not specifically targeted at employment taxes, may have an effect on such taxes. For example, as part of a proposal to provide consistent treatment for all taxpayers for dependent care expenses, the report includes an option to repeal the exclusion for employer-provided dependent care assistance. This proposal would have an effect on both income and employment taxes. Similarly, as part of a proposal to provide more consistent treatment for education expenses, the report includes an option to repeal the exclusion for tuition reductions. This proposal would likewise have an effect on both income and employment taxes. Other proposals that would have the effect of modifying exclusions or the calculation of net income from self employment could also have effects on employment taxes.

Proposals beyond those contained in the Joint Committee staff report may also merit exploration. For example, as mentioned previously, the National Taxpayer Advocate has a proposal that would extend withholding to all payments to service providers subject to information reporting. Such a proposal raises issues in addition to those raised by the Joint Committee staff option. If adopted, it could also be expected to further increase employment tax revenues.

As another example, the Joint Committee staff option that would impose FICA taxes on all benefits provided on a salary reduction basis could be expanded. One possible option would be to provide that nonretirement employee benefits are subject to FICA taxes. Such a proposal would provide consistent FICA tax treatment with respect to such benefits. A variety of issues would need to be addressed under such a proposal that do not arise under the published Joint Committee staff option. For example, valuation issues do not arise under the published option because the amount of salary reduction is known. However, valuation issues may arise with respect to benefits that are not provided on a salary reduction basis. Other policy issues may also arise. Depending on how broadly this option is designed, it could be expected to increase significantly FICA tax revenues and may also increase Social Security benefits for some individuals.

Proposals Relating to Employment Tax Rates and the Employment Tax Cap

In addition to, or in conjunction with, expanding the employment tax base, the solvency of the Social Security system could be addressed by modifying employment tax rates or the employment tax cap. I present here some possible options for discussion purposes.[8]

[8] The very preliminary estimates presented with respect to these options do not include possible increases in outlays due to increases in benefits.

1. Remove Employment Tax Cap

For the period 2006-2015, removing the cap on wages subject to the OASDI portion of FICA and SECA taxes, and maintaining the present-law rate, is estimated to increase off-budget revenues by $1,477 billion and decrease on-budget revenues by $233 billion, for a net increase in revenues of $1,245 billion overall.

An alternative would be to apply a lower rate to wages above the present-law tax cap. For example, a tax could be imposed at a rate of 2.9 percent[9] on wages above the present-law tax cap. The rate of tax on wages below the tax cap would remain unchanged. The 2.9 percent would be in addition to present-law HI taxes of 2.9 percent. This proposal is estimated to increase off-budget revenues by $352 billion and decrease on-budget revenues by $55 billion, for a net increase in revenues of $297 billion overall for the period 2006-2015.

Removing the cap would help increase the solvency of Social Security and would increase the degree of progressivity of the Social Security tax structure. It would raise marginal tax rates on all earners currently above the cap. Removal of the cap would require a decision as to whether benefits should increase for such taxpayers. Increasing benefits for the highest wage earning taxpayers may not be desirable given Social Security's current long-run imbalances. On the other hand, to raise the taxes on the highest earners without commensurate benefit increases would further break the link between earnings and Social Security benefits. A similar proposal with a lower tax rate for the earnings above the current cap would present similar issues but would raise less revenue.

2. Remove Employment Tax Cap, and Lower Employment Tax Rate

An alternative proposal is to remove the cap on wages subject to the OASDI portion of FICA and SECA taxes, but lower the rate on wages so that the proposal is close to revenue neutral. Such a proposal would not increase Social Security revenues, but is provided as a means of illustrating the trade offs between the rate and the base for the tax. If the tax cap were removed, it is estimated that the rate on the employee portion of OASDI taxes could be reduced by 1.8 percent, for a resulting rate of 4.4 percent.[10] This proposal would result in a decrease in revenues of $2.2 billion over the period 2006-2015.

Removal of the cap while lowering the rate would have effects similar to the first option above with respect to progressivity of the Social Security, though to a greater degree. Taxes would rise for high earners and fall for low earners, increasing the degree of progressivity of the Social Security tax structure. These changes would increase labor supply incentives for workers currently below the cap, while decreasing such incentives for those above the current cap. Similar to the first option (and raising similar issues), a decision would have to be made as to whether higher wage taxpayers would also receive higher benefits due to the expanded wage

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[9] It is assumed that one-half of the rate increase is imposed on employers and one-half on employees.

[10] It is assumed that the rate on the employer portion of OASDI taxes remains the same as under present law.

base. Also, just as increasing benefits for the highest wage earning taxpayers may not be desirable given Social Security's current imbalances, this option's lowering of the rate of tax might be similarly viewed.

3. Raise the Employment Tax Cap to Apply to 90 Percent of Covered Wages

Raising the employment tax cap so that it applies to 90 percent of covered wages in 2006 and thereafter would result in a tax cap of $170,000 for 2006 (from a projected cap of $93,000 under present law). For the period 2006-2015, this proposal would increase off-budget revenues by $664 billion and decrease on-budget revenues by $86 billion, for an increase of $578 billion overall.

Raising the cap to cover 90 percent of wages would help increase the solvency of Social Security. Applying OASDI taxes to 90 percent of covered wages was expressed as a goal of Congress in the past when issues of Social Security solvency were being addressed.[11] Over time, indexation has not maintained this level because of greater earnings growth of individuals with wages over the tax cap.

Raising the cap would place the greatest relative burdens on those with earnings near the new cap, and cause marginal tax rates to rise sharply for those with earnings between the new and the old cap. For this reason, this change could be viewed as regressive as the "lower wage" segment of those with earnings above the current tax cap would experience the greatest percentage increase in taxes. The same issues as in the options above arise as to whether benefits would increase for the affected taxpayers.

4. Raise Employment Tax Rate

The rate of OASDI tax could be increased. For example, increasing the OASDI tax rate by one-percentage point (one-half of which would be imposed on employers and one-half on employees) would increase off-budget receipts by $579 billion and decrease on-budget receipts by $61 billion, for a net increase in revenues of $519 billion overall for the period 2006-2015.

Raising rates without altering the cap would help increase the solvency of Social Security. Marginal tax rates would increase for taxpayers below the cap, but remain unchanged for those above the cap. Regardless of the rate chosen, this approach distributes the increased tax in direct proportion to a taxpayer's current tax–that is, it maintains the current degree of progressivity of the Social Security tax and benefit structure. Since the tax base is not changed, this approach does not automatically raise issues related to the benefit side of Social Security that arise when the tax base is altered.

[11] See H.R. Rep. No. 95-702(Part I), 95th Cong., 1st sess. and H.R. Conf. Rep. No. 95-839, 95th Cong., 1st sess.

5. Additional Options

Congress could increase the solvency of Social Security by seeking revenues outside of the traditional payroll tax approach. Clearly there would be many ways to do this, spanning all of the Federal government's revenue sources. But all revenue raising measures would necessarily involve base broadening or tax rate increases.

Seeking revenues outside of the payroll structure would represent a major change to Social Security financing. Depending on how the revenue was raised, the Social Security system could become either more progressive or less progressive. To the extent Social Security is funded from general Federal revenues, some might view the change as further breaking the link between earnings and Social Security benefits.

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The Joint Committee staff looks forward to working with the Committee on the proposals contained in the report, as well as in developing additional proposals of interest to the Committee.

Thank you for the opportunity to testify.