

PLAYING THE FICA GAME

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Pop Quiz:

What do you buy when you pay income taxes?

What do you buy when you pay self-employment tax?

Before I give you the answers.....

Tax planning is a very important part of long term comprehensive financial life planning. One can build a strong foundation for financial security by taking full advantage of tax-favored accounts (IRAs, Roths, SIMPLES, 401Ks, HSAs, etc.).

But there's another part of tax planning that takes advantage of the tax laws to increase the odds of long term financial security: the self-employment (SE) tax.

The SE tax goes by many names (which I will use interchangeably), social security tax or FICA being the most common. (For simplicity, I'm ignoring the Medicare portion of that tax.)

If you are a W-2 employee, your FICA is withheld from your paycheck and matched by your employer. Also, if you are a W-2 employee, you probably have better things to do than to read the rest of this blog. This isn't about you.

If you are a sole proprietor, you have no doubt been dismayed that about 15% of your bottom line goes to the self-employment tax. Sometimes it's more than your income tax! The same goes for those of you who are active members of business partnerships.

How to get around paying this tax?

Many of you reading this blog have made the s-election so that you are taxed as an s-corporation. You know how that works, but let me reiterate.

An s-corporation owner generally wears two hats. She's an owner, of course. But she is also an employee. As an employee, her FICA is withheld from her paycheck and matched by her employer (herself, really). But her share of the company's profits, while subject to income tax, are not subject to SE tax. It's like working at

General Motors AND having some GM stock. Your wages are subject to FICA; your dividends are not.

Suppose the company makes \$100,000, but the owner's salary is only \$20,000. She just saved about \$12,000 in taxes ($(\$100,000 - \$20,000) * .15$). What a deal!

We call this "playing the FICA game." One of the rules governing the FICA game is that your salary has to be reasonable given the work that you do. Unless our example sits on a beach on an island in the South China Sea sipping mai-tais while her employees make money for her back in Park City, the \$20,000 salary is probably way too low.

For the IRS, catching people who are cheating in the FICA game should be low hanging fruit. The company's profits and the owner's salary are right there on page one of the form 1120-S. But the IRS is understaffed, under resourced, and grossly inefficient. So audits resulting from playing the FICA game are rare (but not non-existent).

So why not take your chances and play the FICA game?

Let's go back to that pop quiz.

What do you get when you pay income taxes? Nothing.

What do you get when you pay self-employment tax? The very best longevity insurance annuity that money can buy.

There are a lot of social security sceptics out there, and you might be one of them. But I am not one of them. For many of my clients, social security will be their main source of income in the old folks' home. It might even be their only source of income!

OK So where am I going with this? Here's my advice:

If you want to reduce your taxes, reduce the right ones, i.e., your income taxes. There are so many perfectly legitimate ways to do so. (No, buying a Prius is not one of them.) Fund your HSAs; fund your IRAs; fund your Roths; fund your 401Ks.

Do it early and do it often. If you do that, you will be able to buy a lot more Jello and Bingo tickets in the old folks' home than your friends who played the FICA game while overpaying their income taxes.

But for those of you who are BOTH playing the FICA game AND not taking advantage of the laws regarding retirement accounts, don't expect me to share my Jello or my Bingo winnings in the old folks' home with you.