Saving by Paying

A Wall and Ceiling Contractor Can Save Money by Paying His Employees’ Social Security Taxes

By John W. McDaniel and Jane L. Martin

In May 1978 the Craven County Hospital Corporation, a 259-bed, acute-care facility located in New Bern, North Carolina, granted its 850 employees a wage increase averaging 8%. Yet the hospital expects to save as much as $50,000 this year as a result of the increase.

How does the hospital expect to accomplish this? The hospital is paying its employees’ portion of their FICA (social security) taxes. In effect, the institution is raising its workers’ take-home pay while reducing its overall payroll costs. This procedure is perfectly legal and aboveboard, and any organization that pays social security can install it. While the amounts saved per employee are small, in a large organization they can amount to a considerable benefit. Moreover, the amounts saved will increase greatly through 1987 as increments in the social security tax rate and in the worker salary base, mandated in 1977, take effect. In 1979 the employer and the employee each pays 6.13% of the wage in FICA tax; by 1987 the rate will have climbed to 7.15%. This year the tax is paid on the first $22,900 of salary; by 1987 the base will have risen to $42,600.

By corporate standards the payroll of the Craven County Hospital, $6.2 million in 1978, is not large. Yet the hospital projects a saving from this program of more than $1 million in the 10 years 1978 to 1987. The hospital forecast the windfall based on these assumptions: current wages under $17,700 (the maximum subject to tax in 1978), $6 million; current wages over $17,700, $162,000; annual employee growth rate, 5%; and annual pay increase, 7%.

How it works

The Social Security Act of 1937 and subsequent changes allow the employer to pay the employee’s share of FICA tax as well as his own share. In fact, the act encourages this step by stating that the worker’s share of FICA, if paid by the employer, is not subject to tax. In other words, there is no FICA tax on the FICA tax.

(The legal provisions are set forth in Chapter 21 of the Internal Revenue Code-Federal Insurance Contributions Act, Section 3121(a), along with various regulations and court decisions on the issue of whether the employer may pay—not merely withhold—the employees’ portion of the FICA tax and what the results of such a payment would be. Revenue Ruling 74-75 provides additional information.)

Let us see what effect this program would have on the case of a person earning $10,000 in 1979. Married, with two dependents, this person files an income tax return jointly with his or her spouse. The Exhibit compares the results in the usual approach with those in the new method.

If the employer left his salary at $10,000 and paid the employee’s FICA, his payroll costs would immediately rise by 6.13% over 1978. Obviously this would be unacceptable to most employers unless they had been contemplating a wage increase anyway.

If, however, the employer adjusts the worker’s salary by the amount

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of increased taxes, he can stabilize his pay costs. In this example the employee saves $7.62 and the employer saves $75.16; both come out ahead.

While the payment of the worker’s share of FICA is not FICA taxable, it is income taxable. Therefore the employer must add the FICA tax to the employee’s salary for computation of W-2 earnings.

It goes without saying that employees must be prepared by the employer to accept what, on the surface, appears to be a reduction in salary. At the Craven County Hospital we sat down with each employee and explained the proposed differences. As a result we obtained general acceptance of the program.

Acceptance in a large corporation or non-profit organization may be more difficult to gain. To make sure that workers understand that this approach is no gimmick but a legitimate improvement of the compensation package, the employer with a large work force may find it helpful to personalize his proselytizing with techniques like letters of explanation and a “before” and “after” paycheck display for each employee.

Advantages and Disadvantages

This different FICA technique provides a number of advantages to the employer:

1. Since it eliminates “unnecessary” taxation, the employer can extend larger pay increases than the voluntary wages guideline of 7% and stay within the guideline. Inasmuch as the guideline is based on his unit cost, the employer can grant a 7.9% raise in take-home pay at only a 7% cost to him.

2. Through savings generated by this program, the employer can add to workers’ nontaxable or tax-deferred fringe benefits, such as retirement plans.

3. Because IRC Section 3306(b)(6) exempts from unemployment insurance tax any employer payments of the worker’s social security tax (as long as there is no tax deduction from wages), the employer can save federal and state unemployment insurance taxes.

4. The employer can gain interest income because of slower payment of FICA taxes and unemployment taxes. FICA tax payments for employees whose salaries are under the base are spread evenly over the
year, while payments for those over the base can be made at a slower rate. So the employer can put his cash to use for a longer time.

5. Since employees receive more take-home pay, the employer can gain a competitive edge in the job marketplace.

6. Because FICA is not required to be withheld from wages paid on a sick pay plan, the employer can obtain a further saving.

To be sure, there are potential disadvantages associated with the program:

1. It requires numerous procedural changes in the payroll personnel and other departments. For instance, the program introduces a new way of computing taxes: the employee has a FICA base salary and a W-2 base salary, whereas before he had only the latter.

2. It may cause a reduction in certain worker benefits that are based on W-2 earnings, especially in corporations and other private organizations. These benefits include life insurance, retirement plans, and profit-sharing arrangements. The employer, of course, can adjust the formulas to restore the (usually small) drop in W-2 earnings.

3. If the employer does not adequately educate employees about the advantages of the program, the decline in gross pay (offset, of course, by a rise in net pay) may generate ill will toward the organization.

Whatever difficulties may arise fade in importance when you consider the benefits to both the worker and the employer. For each employee under the FICA base, the procedure can save up to $172.10 in FICA taxes in 1979. Furthermore, the saving will rise in future years, along with ancillary cuts in income taxes and unemployment taxes.

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Exhibit
Revised FICA method compared with traditional method

<table>
<thead>
<tr>
<th>Traditional approach</th>
<th>Revised approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Less FICA paid by employee</td>
<td>613.00</td>
</tr>
<tr>
<td>After-FICA net pay</td>
<td>$ 9,387.00</td>
</tr>
<tr>
<td>Less federal tax†</td>
<td>1,400.00</td>
</tr>
<tr>
<td>Less state tax†</td>
<td>600.00</td>
</tr>
<tr>
<td>Take-home pay</td>
<td>$ 7,387.00</td>
</tr>
<tr>
<td>Employer’s cost:</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>salary</td>
<td></td>
</tr>
<tr>
<td>Plus employee’s FICA</td>
<td>$10,613.00</td>
</tr>
<tr>
<td></td>
<td>$10,537.84</td>
</tr>
</tbody>
</table>

*Computed on $10,000.00
†Computed on $9,962.42 ($9,387.00 and 50% of total FICA paid).

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