Earned Income Calculation for Self-Employed Owners

RETIREMENT MANAGEMENT SERVICES, LLC
Plan Consulting • Administration • Design

RETIREMENT MANAGEMENT SERVICES, LLC
905 Lily Creek Road Louisville, KY 40243
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The proper allocation of contributions and performance of compliance testing for a qualified retirement plan hinges on each eligible employee's plan compensation. Contributions and compliance testing results are only correct if the plan compensation has been accurately determined.

If the sponsoring company is a partnership, an LLC taxed as a partnership, a sole proprietorship or a farming operation, any plan participant who is an owner must use self-employment income as plan compensation. The determination of an owner's plan compensation depends on the accountant's calculations of the owner's self-employment income and whether the company has common-law (W-2) employees covered by the plan.

For such companies, we ask for all of the owners' *preliminary* Schedule K-1, Schedule C or Schedule F, as applicable to use as a starting point in calculating plan compensation. The calculation begins with net Schedule C income, net Schedule F income, or, for partnerships, Schedule K-1 Line 14 (Code A) income, which often needs to be reduced for certain expense items, such as the Section 179 deduction. This is a preliminary determination. Plan compensation for self-employed individuals is also reduced for retirement plan contributions so plan compensation *will change* depending on the level of contribution calculated for the individual.

Starting with the preliminary calculation of self-employment income, reductions are made for ½ the owner's self-employment tax and the owner's contribution to the qualified retirement plan. This adjusted plan compensation will then change the contribution amount, and a circular pattern of calculations is performed until the plan compensation can be finalized. If the preliminary compensation provided on Schedule K-1, Schedule C or Schedule F does not already have the owner's share of the contribution for the common law employees deducted, then prior to finalizing the contributions for the owner, we must receive a *final* version of these schedules and perform the calculations one last time.

Example if the contribution rate = 10%:

Preliminary Schedule C Compensation	$120,000
Less Owner's Share of Staff Retirement Contributions	$ 20,000 ($200,000 eligible payroll times 10%)
Schedule C Net Income	$100,000
Less ½ Owner Self Employment Tax	- $ 7,065 ($100,000 x .9235 x ½ SE tax rate)*
Schedule C Income Net ½ SE Tax	$ 92,935
Less Owner Retirement Contribution**	- $ 8,449 (10% of owner's plan compensation)
Owner's Plan Compensation	$ 84,486 (final compensation less contribution)

**We used a simplified SE Tax calculation for purposes of this example.*
*** Note that the final retirement contribution for the owner is 10% of the owner's plan compensation which is calculated AFTER deducting the owner's retirement contribution.*

Because there is a limit to the amount of plan compensation that can be considered for retirement plan purposes (the limit is $280,000 for 2019), the circular calculations are not necessary for self-employed individuals with self-employment income above a certain level. This level will change from year to year as the maximum compensation limits, maximum self-employment tax and maximum contribution levels are indexed.

While guaranteed payments made to partners does affect the final calculation of self-employment income, they are not considered plan compensation. That said, partners can withhold pre-tax deferrals from guaranteed payments or other cash advances, but if the self-employment income that is calculated later does not support the level of contributions (in other words, compensation is less than the amount deferred or is a net loss), refunds of the excess deferrals will be necessary and employer contributions may be limited.

Plan compensation is defined by the plan document and, for W-2 employees, is usually readily available from payroll records. For self-employed individuals, plan compensation for testing purposes cannot be guaranteed payments, draws, or limited to partner income that is reported on a Form W-2. In short, those calculations are more complex and should be carried out in tandem with the company Certified Public Accountant's calculation of the self-employment income.

Retirement Management Services, LLC
905 Lily Creek Road
Louisville, KY 40243
www.consultRMS.com Phone: 502-429-0767