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The Circular Challenges of Earned Income and Plan Compensation

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Using the incorrect calculation of plan compensation for owners with earned income may expose the plan to compliance and operational failures, jeopardize the tax qualified status of the plan, and require additional contributions to non-owner participants.

Although the Tax Cuts and Job Act of 2017 created a deduction from a taxpayer's Qualified Business Income under Section 199A, the new tax law did not impact the methodology for converting earned income to compensation used for qualified plan purposes.

For practitioners of qualified plans subject to earned income calculations, the starting basis remains the

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taxpayer's individual tax return and the amount of income derived from self-employment. However, the correct computation of plan compensation for an owner-employee remains a complex circular formula that is directly affected by many other factors.

Entities Generating Earned Self-Employment Income to Business Owners

Sole Proprietorships, Partnerships, and LLCs and LLPs Electing to Be Taxed as Unincorporated Entities

Certain entities do not provide owner-employees with a salary that is reportable on Form W-2. In those situations, the owner-employees are provided with income that is the result of their ownership of the company. Instead, the owner-employees earn something called net earnings from self-employment from a trade or business to the extent that the owner's services are a material income producing factor in the business. These types of entities include sole proprietorships, partnerships, and entities taxed as partnerships (for example, limited liability companies taxed as sole proprietorships or partnerships).

For sole proprietors, business income and expenses are reported on Schedule C to the Form 1040. The net profit (or loss) from Schedule C is further reflected on Schedule 1, Line 12 to the Form 1040 (2018 Form 1040). The amount reported on Schedule 1, Line 12 represents what the sole proprietor earned for his/her work at the sole proprietorship. Commonly, a spouse also will perform services for the sole proprietorship and the spouse's income is reported on Form W-2 as an employee of the entity.

In a regular partnership, there are multiple partners who may or may not have the same ownership percentage in the business entity. The partnership's income and expenses are reported on Form 1065, with each partner's share of the business income and expenses reported on Schedule K-1 to the Form 1065. Each partner's Schedule K-1 income passes through to the individual's Form 1040. Hence, this is commonly called "pass-through income"—no income is taxed at the entity level; all income passes through on the K-1 to the individual partners.

In business entities, such as limited liability companies (LLCs) and limited liability partnerships (LLPs), the owners may elect whether the entity is taxed as a corporation or a sole proprietorship/partnership. Generally, the default election is that the entity is taxed as either a sole proprietorship or partnership; however, this election always should be confirmed with the client and the client's certified public accountant.

Caution! S-Corporations Are Different!

Shareholders of an S-Corporation are both business owners and employees. Compensation paid to the shareholders for services performed as an employee is reported on Form W-2. Distributions from the S-Corporation or "dividends" paid to them—that is, amounts paid to them as gains due to owners of the company—are reported on a Schedule K-1; those amounts are not considered to be earnings due to the efforts of the business owner, but the fruits of ownership, unlike the treatment of partnership K-1 income.

Commonly, owners in an S-Corporation will reduce the income reported on Form W-2 and will increase the S-Corporation distributions to avoid payroll taxes (that is, FICA and FUTA) on the part of their income derived from the business profits. While the shareholder may not distinguish between these two classifications of income in his or her own mind, other than the fact that they experience a tax savings, these two types of income are very different from a qualified plan perspective. Although this strategy reduces the individual's payroll tax liability, the unintended consequence is that the amount of compensation used for qualified plan purposes is only the Form W-2 portion. Having lower owner plan compensation can negatively impact the annual nondiscrimination testing requirements, particularly if compensation reported on the Form W-2 is capped at the Social Security Taxable Wage Base in effect for the calendar year.

The Plan Sponsor Is Subject to Self-Employment Income—Now What?

The first step in computing eligible plan compensation for the self-employed taxpayer is gathering the relevant data needed. This may include the following:

1. Draft Schedule C to Form 1040 (line 31) or Form C-EZ to Form 1040 (line 3) for a sole proprietor; or draft Form(s) K-1 to Form 1065 (line 14).
2. Forms W-2 for other employees of the entity.
3. Copies of Forms W-2 for the owner, if the owner was paid W-2 income from any other source for the tax year.
4. Required staff contributions and the owner's desired contributions to all plans maintained by the entity.
5. Elective deferrals made by the owner/partner for the year (while this does not impact the calculation of eligible plan compensation, deferrals will

impact the overall Internal Revenue Code (Code) Section 415 limit for the individual for the limitation year).

Once all of the relevant documentation is obtained, the self-employment income is converted to earned income for plan purposes. The formula for this conversion subtracts from the self-employment income reported on the taxpayer's applicable return an amount equal to one-half of the employment taxes required under Code Section 164(f) and the employer contribution to the qualified plan on behalf of the self-employed individual. This sounds simple enough, but can be quite complicated if all of the variables are not known. Before starting the calculations, confirm whether the self-employed individual's income has been reduced for the applicable portion of the staff's employer contribution. For example, a sole proprietor sponsoring a safe harbor 401(k) plan may have a required contribution to the eligible employees totaling $10,000. If the sole proprietor's self-employment income is $200,000 and the deduction for the staff cost has not been subtracted from that amount by the accountant, then the starting point for earned income is $190,000 ($200,000 less $10,000).

Deduction for One-Half of Employment Taxes

Self-employed individuals pay for both the employer and employee halves of the Federal Insurance Contributions Act (FICA) tax, a mandatory tax that pays for Social Security retirement benefits and Medicare. Because the self-employed taxpayer pays both halves of the tax, the individual can deduct the employer portion of the tax from adjusted gross income (similarly, an employee does not pay taxes on their employer's contribution to FICA).

The calculation of the applicable FICA taxes can be found on Form 1040, Schedule SE (short or long form). The mechanics are as follows:

1. First reduce net earnings (net of the taxpayer's portion of the staff employer contribution) by multiplying it by a factor of .9235 (in the above example, this would equal $190,000 times .9235, or $175,465). The factor of 92.35 percent of earned income is taken directly from the Schedule SE to the Form 1040.
2. The Social Security portion of the employment tax is currently 12.4 percent of the amount determined in step one above, but only up to the Social Security Taxable Wage Base for the tax year ($128,400 for 2018; $132,900 for 2019). Because the amount from step one ($175,465) is greater than the taxable wage base of $128,400, the Social Security portion of the tax is 12.4 percent times $128,400, or $15,921.60.
3. The Medicare portion of the employment tax is currently 2.9 percent; however, there is no compensation cap on the Medicare tax. Therefore, the Medicare portion of the tax is 2.9 percent times $175,465, or $5,088.49.
4. The total of the employment taxes for our sole proprietor is $15,921.60 plus $5,088.49, or $21,010.09.
5. One-half of the self-employment tax is $10,505.05 (50 percent of $21,010.09).
6. In our example, therefore, the earned income is $190,000 (not the 95.35 percent of that amount), minus $10,505.05 or $179,494.95.

Historical Note: In 2011, taxpayers benefited from the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 which created a "payroll tax holiday period." The payroll tax holiday was subsequently extended in the Temporary Payroll Tax Cut Continuation Act of 2011 through the 2012 tax year. During 2011 and 2012, the Social Security tax withholding was reduced from 12.4 percent to 10.4 percent; however, the Medicare portion of the tax remained at 2.9 percent.

Determining Eligible Plan Compensation

Now that the variables of the staff cost and the self-employment taxes have been deducted from net earnings, we have the amount of compensation for the sole proprietor prior to the calculation of the employer contribution on behalf of the sole proprietor. $200,000 in earned income less $10,000 for the staff contribution and $10,505.05 in employment taxes yields $179,494.95. However, $179,494.95 is not the amount of compensation used for plan purposes. The $179,494.95 must be reduced by the sole proprietor's "employer" contribution on his or her own behalf. If the dollar amount of the contribution is known, the calculation is straight forward. For example, if the sole proprietor's contribution is $15,000 for 2018, then the compensation used for plan purposes is $164,494.95 ($179,494.95 less $15,000.00). If the sole proprietor's contribution needs to be a certain percentage of eligible plan compensation, then a mathematical formula must be used.

The mathematical formula for calculating a percentage of eligible plan compensation is one divided by the sum of one plus the desired percentage (1/(1+X %)), multiplied by the reduced compensation prior to the individual taxpayer's contribution. If the sole proprietor had a safe harbor plan with a 3 percent non-elective formula, the calculation of eligible plan compensation and the 3 percent required contribution would be as follows:

- \$179,494.95 × 1/(1 + .03) = \$174,266.94 (eligible plan compensation)
- The safe harbor contribution is then \$174,266.94 × 3% = \$5,228.00

We can check the accuracy of this calculation by dividing the contribution (\$5,228.00) by compensation we calculated (\$174,266.94) to be sure it equals 3 percent (and it does)!

A Recap before Moving Forward

The sole proprietor started out with company profits totaling \$190,000. From that amount, the taxpayer will pay \$21,010.09 in employment taxes, elects to make a pre-tax salary deferral of \$18,500 to the 401(k) plan and is required to contribute \$5,228.00 to him or herself as a safe harbor non-elective contribution. The net of that calculation is the amount the sole proprietor actually has available to spend, or \$145,261.91.

The taxpayer's eligible plan compensation is \$190,000 less one-half of the self-employment tax (\$10,505.05) less \$5,228.00, which equals \$174,266.95. We can double check this amount by taking the spendable income that we calculated of \$145,261.91 plus the salary deferral of \$18,500 plus the self-employment tax deducted of \$10,505.05, which also yields \$174,266.95. Note here that the salary deferral does not reduce the taxpayer's earned income, in the same way that deferrals by an employee paid on Form W-2 do not reduce the employee's Code Section 415 compensation. Another item of which to be cautious in calculating eligible plan compensation for owner-employees is that the eligible plan compensation used in the mathematical formula cannot yield more than the dollar limit under Code Section 401(a)(17) in effect for the plan year. For 2018, that dollar limit was \$275,000. (For 2019, it is \$280,000.) Likewise, the contribution calculation (including both the employer contribution and the employee's salary deferrals) cannot exceed the annual additions limitation (\$55,000 for plan years ending in 2018; \$56,000 for 2019).

As a reminder, the deductions for plan contributions on behalf of regular non-owner employees is subtracted before determining the net earnings from self-employment on the Schedule C or the Schedule K-1. The deduction for the employer contribution on behalf of the self-employed taxpayer will be reflected on Form 1040.

Multiple Businesses

Earned income calculations become increasingly more complicated when the client dabbles in more than one entrepreneurial venture. Suppose the self-employed client is an attorney and a musician. The client earns income from both occupations; however, these businesses are treated separately for tax purposes. Is the income from both businesses counted when determining eligible plan compensation? Well, that depends on which business is the actual plan sponsor. If the sponsor is one or the other, then only the income derived from that particular business is counted for plan purposes. It also is possible that both entities sponsor the plan, in which case, the income as an attorney and a musician would be counted in the earned income calculations.

Another common example is a self-employed attorney who also is a partner in a law firm. The attorney would receive income from his sole proprietorship (reported on Schedule C) and would receive his share of the law firm's pass through income (reported on Schedule K-1). Again, the only income that may be counted for plan purposes is the income associated with the sponsor(s) of the qualified retirement plan. If the plan covers both entities—for example, in an affiliated service group arrangement—then the earned income from both entities would be counted. The earned income calculation is the same regardless of whether there are one or more entities involved.

Practice Tip: When there are multiple businesses involved, the most important factor is confirming which entity(s) sponsors the qualified retirement plan.

What if the self-employed client also works as an employee for another business and is paid on Form W-2 for his services as an employee? A good example of this occurrence is a self-employed physician who has his own practice and also works as an employee of the local hospital. The physician would have two sources of income, the self-employment income from his practice reported on Schedule C to the Form 1040, plus the income paid by the hospital on Form W-2. This is a perfect example of when the earned income calculations become more complicated. The physician in our example will have paid some of the applicable FICA taxes on his W-2 earnings. When determining the self-employment taxes subject to the one-half deduction noted previously, those taxes first must be adjusted for any amounts already paid. Here's an example: Suppose the physician earned more than $128,400 from the hospital, paid on Form W-2. In this case, the physician already has paid the full amount of the Social Security portion of the FICA taxes on his W-2 income, so there would be no FICA taxation of 12.4 percent of his earnings from his sole proprietorship for Social Security retirement benefit purposes. However, the Medicare portion of the FICA taxes would still be applicable, as there is no income cap on the Medicare tax.

Practice Tip: Consult with the client's certified public accountant to confirm that the earned income calculations are accurate.

What Happens if There Is a Net Loss?

Although the regulations do not include a definitive answer as to the treatment of earned income when one entity has net income and the other has a net loss, the Internal Revenue Service (IRS) has informally indicated that the net loss may be treated as zero income, rather than an offset to the entity with positive net earnings. If that situation occurs for a self-employed individual with more than one business, the earned income for plan purposes would be calculated from the entity that had positive income. If both entities have a net loss, then the self-employed individual would have no earned income for plan purposes. Practitioners should be aware of this when working with their clients, as that also would mean that the self-employed individual would not be permitted to make salary deferral contributions for that tax year.

Based on the complexity of determining earned income that is counted for qualified plan purposes, practitioners who are not savvy in calculating plan compensation should rely on the taxpayer's certified public accountant. Most accountants will be able to provide the calculations for the third party administrators. Similarly, if the third party administrator calculates earned income for the client, it is a best practice to have the accountant review the calculations. Because many taxpayers extend the due date of their individual tax returns, many third party administrators are provided drafts or estimates of the earned income amounts so that the taxpayer can plan the contributions and deductions accordingly. There are other expenses that may impact the earned income calculations, such as Section 179 deductions, which should be discussed with the accountant preparing the taxpayers individual return. Even though the new Section 199A deductions do not directly impact the earned income calculations, those limitations may impact the amount the taxpayer may deduct as employer contributions. This is particularly important if the taxpayer sponsors a cash balance plan with substantial contribution credits.

Nondiscrimination Testing

If the qualified plan sponsored by the self-employed individual is subject to nondiscrimination testing (that is, covers employees other than the owner and the owner's spouse), it is critical that the earned income is calculated correctly. There are many examples of how using an estimate of earned income to complete nondiscrimination testing can backfire, but a few examples should demonstrate the potential operational failures that could occur.

First, consider a 401(k) plan that is subject to the Average Deferral Percentage (ADP) Test. The practitioner is told that the owner's income is "well over $275,000" for the 2018 year and that the owner (who is the only highly compensated employee) made deferrals of $11,000 for 2018. The non-highly compensated employees' deferral average is 2 percent of compensation; therefore, the maximum highly compensated deferral average is 4 percent of compensation. Using compensation for the owner of $275,000, the ADP Test is satisfied, because the owner's average is 4 percent ($11,000 divided by $275,000). What the owner failed to communicate to the practitioner is $275,000 was only an estimate of the gross earnings for the year. Subsequently, the plan is selected for audit by the IRS and the agent discovers that the compensation used in the nondiscrimination testing should have been $250,000. Because the owner's testing compensation is lower, the ADP Test actually fails. The highly compensated owner's deferral average is 4.4 percent ($11,000 divided by $250,000), which is greater than the maximum allowed 4 percent of compensation.

Another good example is a plan that uses a new comparability formula for allocating the profit sharing contributions. One of the tests that must be satisfied is the minimum gateway contribution, which is the lesser of one-third the rate provided to the highly compensated employee with the greatest allocation rate or 5 percent of compensation. Originally, the owner's earned income for plan purposes was determined to be $150,000 and the owner (also the only highly compensated employee) has decided to allocate 9 percent of compensation to himself (9 percent of $150,000 is $13,500) and 3 percent of compensation to all of the eligible non-highly compensated employees. Assuming all other applicable testing is satisfied, this allocation would meet the minimum gateway contribution requirement. However, the owner and his accountant found additional deductions that reduced the owner's earned income to $125,000. Nonetheless, the owner deposited $13,500 to his account and did not adjust the amount to the employees. Based on the owner's earned income of $125,000, the minimum allocation to the non-highly compensated employees is now 3.6 percent of compensation, rather than 3 percent of compensation. The plan no longer satisfies the annual nondiscrimination tests and the plan may be in jeopardy of losing its tax qualified status if the operational failure is discovered upon audit.

The above examples are certainly extremes in the application of earned income calculations; however, practitioners should be aware that simply using the compensation limit for the applicable plan year can result in plan disqualification. As a best practice, it is recommended that source documents be obtained to confirm that the plan compensation being used for the self-employed taxpayer is accurate each year. Assumptions can be quite costly, and it is likely that the owner will want to point fingers at the service providers should the plan fall under scrutiny by the IRS.

Practice Tip: Using incorrect earned income may have unexpected consequences when applying the applicable annual nondiscrimination tests.

Tips to Avoiding Compliance Headaches

If your client indicates that she had earned income equal to the compensation limit in effect for that year, make sure to request a copy of the applicable tax schedules. Many clients are wary to provide this information to service providers, as they do not understand the implications of using the incorrect plan compensation. Having a discussion with the owner and documenting everything in writing will save many headaches down the road when neither party remembers how the compensation was derived.

If in doubt, get the owner's accountant to review the calculations. Similarly, if a practitioner is not an expert in earned income calculations, then partnering with the tax advisor will ensure that the earned income calculations are accurate and that the plan remains in operational compliance.

Conclusion

Plans sponsored by self-employed individuals present unique challenges to practitioners who are performing nondiscrimination testing and determining deductible contributions for their clients. While the application of the self-employment calculation itself does not seem altogether that difficult, the reality is that every client has a unique situation. There are unlimited variables that can impact the determination of earned income used for qualified plan purposes. To avoid unintended compliance and operational failures, practitioners should work closely with the self-employed clients and their tax advisors annually to correctly determine the earned income which may be counted as eligible plan compensation. ■

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