Calculation of Plan Compensation for Sole Proprietorships

This Issue Snapshot will discuss the calculation of plan compensation for those sole proprietors who maintain qualified retirement plans under IRC Section 401 and SEP IRA plans under IRC Section 408(k).

IRC Sections and Treas. Regulations

- IRC Section 164(f)
- IRC Section 401(c)(2)(A)
- IRC Section 404(a)(1)
- IRC Section 404(a)(3)
- IRC Section 404(a)(7)
- IRC Section 404(a)(8)
- IRC Section 404(o)
- IRC Section 1402

Resources

- Announcement 94-101
- Publication 560
- Form 1040, Schedule C
- Form 1040, Schedule SE
- LaFlamme v. Comm'r, T.C. Memo 2012-36

Analysis

Earned Income:

For self-employed individuals, IRC Section 404(a)(8)(B) provides that "earned income" as defined in IRC Section 401(c)(2) (Earned Income) must be used in place of "compensation" when computing the deductible limit under IRC Section 404(a)(3). Generally, while earned income must be attributable to the individual's personal services in conducting a trade or business, "Compensation" is remuneration for an employee's personal services received in the course of employment to an employer. Self-employed individuals are usually sole proprietors or partners.

Earned Income is used to apply rules to plans covering self-employed individuals in the following plan areas: allocations, accruals, deductions, IRC Section 401(a)(4) nondiscrimination, and IRC Section 415 Limits. Earned Income is also relevant for purposes of computing the limit under IRC Section 401(a)(17). For purposes of applying some of these rules, adjustments specified in the IRC and Treas. Regulations are made to a self-employed individual's Earned Income.

A taxpayer's Earned Income is equal to:

- Net Earnings from Self-Employment (NESE) (IRC Sections 401(c)(2) and 1402(a))
- Adjusted under IRC Section 401(c)(2):
  - Subtract 1/2 Self Employment (SE) tax paid (IRC Section 164(f) deduction)
  - Reduced by contributions to a qualified plan to the extent deductible under IRC Section 404
- Adjusted under IRC Section 401(c)(2)(A)(i) through (iv).

Under IRC Section 404(n), elective deferrals (as defined in IRC Section 402(g)) are not subject to the limit of IRC Section 404(a)(3) and are not taken into account in applying the limit of IRC Section 404(a)(3) to other contributions. Therefore, for purposes of computing the IRC Section 404(a)(3) limit for a plan covering a sole proprietor, the elective deferrals made by the sole proprietor are added to the sole proprietor's Earned Income to compute the sole proprietor's compensation.

Under IRC Section 404(a)(8), contributions to a qualified plan made on behalf of a self-employed individual are considered to satisfy the requirements for deductibility under IRC Sections 162 and 212 to the extent those contributions do not exceed the Earned Income of the individual (determined by increasing that amount by the deductions allowed under IRC Section 404) and are not allocable to the purchase of life, accident, health, or other insurance.

Calculation of Amount of Sole Proprietor Contribution under a Plan Formula Based on Earned Income

If nonelective contributions to a defined contribution plan on behalf of a sole proprietor (the SEI) are determined under a plan's formula as a percentage of the sole proprietor's Earned Income, then the Earned Income calculation is dependent on the SEI's contribution, but the SEI's contribution is also dependent on the Earned Income. If the SEI has made no elective deferrals and the contribution made on behalf of the SEI is fully deductible, this results in the following two formulas:

- Earned Income = NESE – 164(f) Deduction – SEI 404 Contribution Deduction
- SEI 404 Contribution Deduction = Earned Income x Plan Rate

The contribution formula is algebraically restructured to remove the unknown Earned Income variable and replace it with known quantities:

- SEI 404 Contribution Deduction = (NESE – 164(f) Deduction) x (Plan Rate / (1 + Plan Rate))

Once the SEI's contribution is known, Earned Income is easily calculated. To check for accuracy, multiplying Earned Income by the plan rate should result in the contribution calculated previously.

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