How Self-Employed Income Works

When calculating contributions to your retirement plan, determining the correct compensation to use for your employees is fairly straight-forward. Plans will often use an employee's W-2 wages as the basis for calculating plan contributions. Determining the correct compensation to use for self-employed individuals such as sole proprietors and partners, however, is more challenging. A special computation is necessary to determine the contribution for self-employed individuals.

<u>Self-Employment Income</u>

As a self-employed individual, your "compensation" is your net earnings from self-employment. Net earnings take into account the deduction for your self-employment tax and the deduction for your plan contributions (excluding any salary deferrals). The deduction for your own contributions and your net earnings depend on each other. For this reason, you determine the deduction for your own contributions indirectly by reducing the desired contribution rate. This example illustrates how the calculation works:

Step 1. Identify net profits.

- For sole proprietors, this is the amount reported on Schedule C (Form 1040).
- For partners, this is the amount reported on Schedule K-1 (Form 1065).

Step 2. Reduce net profits by ½ of the self-employment (SE) tax deduction.

Step 3. Multiply the Step 2 amount by the desired contribution rate divided by "1 plus the desired contribution rate."

Step 4. Add salary deferrals to this calculated profit sharing contribution.

Example: Jane, age 40, is self-employed. Her Schedule C net profit is $150,000, and she wants to contribute the maximum deductible amount (25%) to her 401(k) plan.

Step 1. $150,000

Step 2. $150,000 - $10,248 (½ SE taxes) = $139,752

Step 3. $139,752 x [.25 ÷ (1+.25)] = $139,752 x .20 = $27,950

Step 4. $27,950 (profit sharing) + $19,000 (salary deferral) = $46,950 (maximum 401(k) contribution)

<u>Adding Employees to the Plan</u>

This interrelated calculation becomes increasingly complex when employees are covered under the plan. The contribution to your staff must be determined first in order to properly compute your self-employment tax. This is because self-employment taxes are imposed on self-employment income determined *after* the deduction is taken for contributions made on behalf of employees.

Example: Going back to Jane and her 401(k) plan, let's now assume that she has two employees covered by the plan, one with compensation of $20,000 and one with compensation of $10,000. Jane still wants to contribute the 25% maximum deductible amount to her 401(k) plan, and the same contribution rate must be contributed to her employees. The 25% profit sharing contribution for her employees is $7,500 (($20,000 + $10,000) x 25%), which impacts the calculation of Jane's contribution, as follows:

Step 1. $150,000 - $7,500 = $142,500
Step 2. $142,500 - $10,248 (½ SE taxes) = $132,252
Step 3. $132,252 x [.25 ÷ (1+.25)] = $26,450
Step 4. $26,450 (profit sharing) + $19,000 (salary deferral) = $45,450
(assuming the special 401(k) nondiscrimination test is met)

Your plan's allocation method will affect the difficulty of this circular calculation. Please contact us to learn how we can help determine your self-employment income and calculate contributions for you and your employees.

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