



I am Self-Employed. What is My Income for Qualified Plan Purposes?

For self-employed persons (including partners in a partnership, LLC or LLP), *earned income* is considered *compensation* for qualified plan purposes. The definition of *compensation* applicable to a self-employed person is defined in the plan. After making several adjustments, up to \$225,000 (for 2007) of *ultra-net* earned income may be considered for calculating the amount of the employer's deduction limit for funding Defined Contribution plans (25% of eligible payroll) or Defined Benefit plans (whatever amount is required to support projected benefits).

In order to determine *ultra-net* earned income, each partner's pre-plan net earnings from self-employment are reduced by half of his/her self-employment tax deduction; his/her own contributions to a qualified plan (elective and non-elective) and his/her share of common law employee contributions to a qualified plan. These calculations are circular, interdependent and require a computer to complete. Other factors such as outside W2 income and self-employment gains/losses must also be taken into account when calculating self-employment tax where applicable. Simply put, the results are needed to determine the beginning. The 25% employer deduction limit for Defined Contribution plans is applied to the result. Solely for purposes of allocating employer contributions, elective contribution amounts may be included in the definition of earned income, but not in excess of \$225,000.

However, Defined Benefit plans using compensation based benefit formulas are a completely different story, and pose a much more complicated set of circumstances. In such plans, benefits and funding amounts are actually based on *Average Compensation*. Furthermore, the plan will also define the *Averaging Period*. For example, a plan might define the Averaging Period to be the highest 3 consecutive years beginning from date of hire. Alternatively, a plan might define the Averaging Period to be the highest 3 consecutive years beginning

from the plan effective date. The length of time the employer has been in business, as well as the consistency of prior and projected profits, must be very carefully considered before choosing an Averaging Period. These issues need to be discussed thoroughly during the plan design process, and you should provide income documentation (IRS Form 1040 with Schedule C and Schedule SE, Schedule K1...) for prior years, or projections for current and future years in the case of a newly formed employer.

For example, let's assume you desire a Defined Benefit plan that allows a contribution of \$145,700. You are a Sole Proprietorship and your *ultra-net* earned income (e.g. net earned income less plan contribution and one-half SET [self-employment tax]) is \$100,000. In order to maintain this desired level of contribution for the current and future years, you must be able to achieve one of the following circumstances:

1. Roughly \$255,000 of gross annual compensation for at least 3 years. This \$255,000 is arrived at as follows: \$100,000 (ultra-net earned income) + \$145,700 (plan contribution) + \$9,300 (roughly one-half of self-employment tax).
2. A *highest 3 consecutive prior years'* average ultra-net earned income for the Sole Proprietorship of \$100,000 AND a net earned income of \$145,700 PLUS one-half self-employment tax for the Sole Proprietorship in each future year.

One must properly consider this issue during the plan design process, or the result can be unexpected increases or decreases in plan contributions. Let's assume your Sole Proprietorship began on 01/01/2005, and your Defined Benefit plan is effective 01/01/2007. Furthermore, assume the plan uses an Averaging Period of *highest 3 consecutive years' average compensation including years prior to the plan effective date*, and requires a contribution of \$80,000. If your 2005, 2006 and 2007 earned income is \$100,000 each, your average compensation for plan purposes is now $[\$100,000 + \$100,000 + (\$100,000 - \$80,000)]/3$, or \$73,333, causing a dramatic decrease in overall plan contributions.

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