# Which Comes First: The Contribution or the K-1? (The Circular Fun of Self-Employed Income Determinations)

## Facts

As a self-employed individual, I run a successful business and have set up a retirement plan to provide for tax-sheltered savings. When its time to determine the contribution amount each year, it feels more complicated than running the business. My CPA seems to be waiting on our TPA, and the TPA waiting on the CPA – and amidst it all, I'm just waiting on my numbers!

## Question

Which comes first, the contribution or the K-1?

## Answer

So, the TPA is correct - they need the earned income from the K-1 to calculate the contribution. But the CPA is right, too – they need the contribution figure to finalize the K-1. If it feels like this is going in circles, it is. Self-employed income calculations are circular in nature, with both the earned income and plan contributions dependent on each other. Coordination between your CPA and plan consultant is the key to making these calculations easy (relatively speaking)!

To help you understand a bit of the mechanics related to this merry-go-round, let's look at what happens in the nitty gritty on the TPA side of things:

- Determine the starting point for earnings based on Form 1065, Schedule K-1, box 14.
- Reduce these earnings by Section 179d expenses for the year, if applicable.
- Calculate the applicable self-employment tax, and reduce the working figure by one-half of that amount.
- Reduce net amount from step #3 by the plan contribution amount.
- The result from step #4 equals the plan compensation, subject to the annual compensation limit.

The critical piece in this abbreviated explanation is Step 4; the employer contribution made to the plan reduces the plan compensation. This is where things get tricky, because as you're likely familiar, the plan contribution is calculated using plan compensation. The inter-dependent nature of the compensation and contribution calculations requires the well-coordinated dance between the CPA and TPA.

When there are employees involved, this dance gets a warm-up routine with an extra level of work. The TPA reduces the starting point of the earned income calculation (Step 1 from above) by any employer contributions made on behalf of the employees. Often the amount of contributions required on behalf of employees is determined based on the contributions made to the owners, so this calculation becomes that much more involved.

How can we make it all work?  To ensure this maddening circular calculation doesn't derail the timing of your tax filings or contribution deposits, it's critical for the CPA and TPA to work together.  Most likely, this means the TPA will be preparing an initial calculation based on a draft K-1, initial contribution figures are then provided to the CPA, an updated K-1 is prepared, and then any final tweaks are made to the contribution calculations. Barring any major changes in the K-1, the non-discrimination testing of contributions is unlikely to change (although not guaranteed so a final review is important).  Since the contributions are most often based on percentages of compensation rather than specified dollar amounts, the adjustments needed for testing are likely to be minimal, if any at all.

One more important note to share related to self-employment income – entity type matters.  When we talk about K-1s and self-employment compensation, we are referring to partnerships and sole proprietorships only. Pass-through income reflected on a K-1 for an S-corporation is not includable compensation for plan purposes. For S-corporations, contribution calculations, allocations, and related testing are based on an owner's W-2 compensation only.

Self-employment income and definitions of compensation can be complex!  DWC is here to make those conversations easier.  If you have any questions related to compensation and calculations, don't hesitate to contact us.

## Related Resources

- Compensation Jeopardy: Things You Might Not Know About Your Retirement Plan
- Nondiscrimination Testing Overview

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