COMPENSATION ISSUES: EARNED INCOME
Sole Proprietors, Partners, LLCs, LLPs

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COMPENSATION ISSUES: EARNED INCOME
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Net Earned Income and Optimization Issues

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I. DETERMINATION OF EARNED INCOME

A. Prior to TEFRA (1982)

1. Contributions for self-employed was straight forward.

2. Common law percentage multiplied by self-employment income without regard to the plan contribution and without regard to self-employment tax.

B. Leveling The Playing Field

1. TEFRA changed the rules to be "more fair" to self-employed.

2. Brought us higher limits and new methodologies.

3. Rules of Thumb:

   a. 13.043% (actually 15/115) of bottom line Schedule C (BLC) for PS plans.

   b. 20% of BLC for MP plans.

4. Earned income for purposes of self-employed plan compensation is calculated by taking into account the deduction for the individual's contribution on his own behalf.

5. Example (post TEFRA / pre 1990):

Corporate Owner: 25% MP Plan	
Compensation (W-2):	$40,000
Plan contribution by corporation:	10,000
Total cost to business:	$50,000

Self-employed Owner: 25% MP Plan	
Schedule C bottom line income (BLC):	$50,000
Contribution to plan (20% of $50k):	10,000
Remaining net income:	$40,000

6. A "bump" in the level playing field.

   a. Self-employed individual pays social security (SS) taxes on his/her BLC income without any adjustments for the contribution to the plan even though the contribution is not taxable for income tax purposes.

b. In the example in 5 above, the self-employed individual pays SS taxes on $50k, while the corporate owner pays SS taxes on $40k.

c. This is only an issue when the earned income (after deduction for plan contribution) is lower than the taxable wage base (for SS tax purposes - $118,500 in 2016). It always will be true for medicare tax purposes since the elimination of the medicare tax cap (was raised from a cap of $51,300 to $125,000 with OBRA '90; and made unlimited in 1994).

d. IRS rationale: Contributions to a plan for a sole proprietor or partner are earnings from self employment and not an expense attributable to the trade or business of the self-employed person. **Rationale; NOT LOGIC!**

C. Changes in Social Security Taxes

1. 1983 amendments to Social Security Act modified IRC 401(c)(2)(A) to require earned income to be reduced by one half of the SS self-employment tax - a deduction provided under IRC 164(f).

2. Prior to 1990, a self-employed individual was given a 2% tax credit which was taken directly from the SS tax calculated on the Schedule SE. Earned income figures were not affected.

3. For pension and profit sharing plan limitation purposes, Code Section 401(c)(2) defined net earnings from self-employment by reference to code section 1402(a), but **"with regard to"** both the self-employed's plan contribution on his own behalf and his code section 164(f) deduction.

4. Code section 1402(a) defined Net Earnings from Self-Employment and provides that we should take into account a separate deduction **"in lieu of"** the 164(f) deduction - see IRC 1402(a)(12).

5. Therefore, it appeared reasonable to believe we might need to take into account two deductions for determining net earnings from self-employment: the 164(f) "with regard to" deduction which is taken on the 1040, and the "in lieu of" deduction under 1402(a)(12) which is taken on the Schedule SE.

6. The Service clarified that the "in lieu of" deduction on the Schedule SE is taken into account **only** for self-employment tax purposes. In computing allowable contributions based on net earnings from self-employment, we ignore the "in lieu of" deductions and **only** take into account the Section 164(f) "with regard to" deduction from the 1040.

7. In order to get this 164(f) deduction, the Schedule C must first be completed and then the Schedule SE. Thus, 1/2 of the Schedule SE determined self-employment tax is deducted from the bottom line Schedule C in order to get to what we will call **Adjusted Schedule C** compensation.

D. Analysis of Schedule SE - 2015 (filing in 2016)

1. Assume sole proprietor with no other employees.

2. Note adjustment on line 4 (Short Schedule SE) of .9235

a. This is the "in lieu of" deduction in IRC Section 1402(a)(12).

"...there shall be allowed a deduction equal to the product of

A. the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph) [in other words, BLC] **and**

B. one half of the sum of the rates imposed by subsections (a) and (b) of Section 1401 for such year." (a is SS rate; b is Medicare rate)

b. The rates in subsection (a), the OASDI rate of 12.4% and (b), the HI (Medicare) rate of 2.9%, total 15.3%. One half of this is 7.65%. Since this is a "deduction", the Schedule SE gets right to the result of that subtraction by multiplying by the inverse, or 1 - .0765 = .9235

3. Prior to the elimination of the cap on the medicare taxes and as a result of this .9235 adjustment, those self-employed individuals whose BLC was equal to or greater than the medicare taxable wage limit ÷ .9235 (for 1993 returns, $135,000 ÷ .9235, or $146,182.99 or greater) and assuming no other earned income on which social security taxes were payable, were able to simply adjust the BLC compensation by a fixed number which changed slightly each year (if there was a cost of living increase). For 1993, that reduction was $5,528.70. From 1994 and on, there is no maximum tax so there is no maximum adjustment.

4. However, the interplay of the maximum compensation limit of $150,000 applicable beginning in 1994 ($265,000 in 2015; $270,000 expected in 2017) and the maximum IRC Section 415 limit now produces a BLC level above which no adjustments need be made. Thus, those individuals whose BLC is at or above $329,762.77 and will be contributing the maximum of $53,0 00(for 2016) need not make any adjustments for the "in lieu of" deduction because at that level and above, the compensation will simply reduce to the maximum level of $265,000. This level will rise each time the maximum compensation limit increases.

Comp - .5(14,694.00) - .5(Comp x .9235 x .029) = $265,000 + 53,000

Simplifying and solving for “Comp”, we get:

<u>$329,762.77</u> - .5(14,694.00) -.5(329,762.77 x .9235 x .029) = 318,000

NOTE: If this is a 401(k) plan and the maximum deferral is reducing the employer contribution, the far right term would be $265,000 + $35,000 (instead of $53,000), and the maximum BLC needed would be only $311,518.47.

5. The 2016 low breakpoint is $128,316.19 (2016 TWB of $118,500 ÷ .9235). If BLC is at or below this level, Adjusted Schedule C compensation will be equal to BLC multiplied by .92935225.

[1 - (.9235 x .153 x .5)] = .92935225

6. If BLC compensation is above the breakpoint in 5 above ($128,316.19 for 2016) but below $329,762.77, the Adjusted Schedule C compensation will be determined by subtracting the result of the following calculation from BLC:

(118,500 x .153 x .5) + (.029 x .5)(.9235 BLC - 118,500)

which simplifies to

9065.25 + .0145(.9235 BLC - 118,500)

which simplifies to

7347.00 + .01339075 BLC

E. Special Problems

1. An individual who has W-2 income in addition to self-employed income.

   a. The long Schedule SE should be completely filled out to reflect the proper SE tax and "in lieu of" deduction.

   b. Prior to 1994, if W-2 income exceeded the medicare taxable wage base, there was no need for SE tax adjustments to earned income. This is no longer the case since all SE income will be subject to, at least, the medicare tax of 2.9% which will yield an "in lieu of" deduction from self-employed income. For qualified plan purposes, however, keep in mind the practical limit shown in D.4 above.

2. An individual who has more than one Schedule C.

   a. Schedule SE is based on combined Schedule Cs.

   b. Do not, therefore, use Schedule SE calculation blindly.

   c. Probably must allocate SE taxes in some reasonable manner.

      (1) If retirement plan applies to only one Schedule C, can we reasonably allocate all SE tax to other Schedule C? Maybe, but not the conservative approach.

      (2) Would pro rata be appropriate? Necessary?

3. Any individual who has multiple sources for SE income will raise the same issues as in number 2 above.

   a. Schedule C - Profit or Loss From Business.

   b. Schedule F - Profit and Loss From Farming.

   c. Schedule E - Supplemental Income and Loss.

      (1) This is where partnership K-1 amounts are itemized.

F. Special Partnership Issues in Calculating SE Tax

1. Partners include any individual who is taxed as a Partner, whether in true partnership, or an LLC, LLP or any other entity electing to be taxed as a partnership.

2. Partnership SE determination has several wrinkles.

   a. Line 14 of Schedule K-1 "appears" to provide the necessary number.

b. The item on this line is determined at the partnership level using a worksheet provided in the instructions to Form 1065 (see Page 35 of the 2015 instructions to Form 1065). It is then allocated to individual partners.

c. The worksheet provides for an adjustment to SE income where there is an ordinary gain or loss on sale of business property (from Form 4797). Basically, you add back in a loss or subtract out a gain. This number only appears on the 1065 and not on the Schedule K or K-1. Thus, it is an **off sheet** adjustment and can explain why line 14 can't always be confirmed by simply adding up the items on the K-1 - line 1 (ordinary business income/loss) and line 4 (guaranteed payments to partner).

3 Other adjustments to get partners actual SE income.

d. The amount shown on the 1040 Schedule SE can differ from the K-1, line 14 (even where there is no other outside earned income such as Schedule Cs, Fs, or W-2 income).

e. Instructions for Box 14 for Schedule K-1 (Form 1065) say to reduce the line 14 amount by certain allowances as explained below (see page 11 in the 2015 instructions). If you do so, you must attach an explanation. This required explanation is referenced on the Form 1040 Schedule SE Instructions (see Page SE-4 under heading Partnership Income or Loss).

f. There are 3 adjustments provided for general partners:

(1) Section 179 expense deduction **claimed.**

(2) Unreimbursed partnership expenses **claimed**.

(3) Depletion **claimed** on oil and gas properties.

4 Section 179 Expense Deduction Claimed.

g. K-1 shows the amount of Section 179 deduction being passed through to the partner (line 12).

h. Form 4562, Depreciation and Amortization, is where the **individual's** deduction limit for Section 179 property is determined. See line 12.

i. This is the amount of the K-1 Section 179 deduction that is "claimed" and therefore is used to reduce the SE income. It actually will show up on the 1040 Schedule E, Part II, line 28, column (i).

5 Unreimbursed partnership expenses claimed.

j. Form 1040, Schedule E, Part II, line 28, column (h): This is where unreimbursed partnership expenses from nonpassive activities are claimed (shown as a separate line identified as UPE; see page E-9 of the 2015 instructions to Form 1040 Schedule E).

II. COLLECTING THE DATA

A. Can We Trust The Accountants?

1. **NO.** We couldn’t trust them in 1990, and we can’t trust them now!

2. We must be precise in our requests for information and then we must **VERBALLY** double check!

3. The accountants must complete all their work up to the point that we do our work. Then, we feed back our results so they can complete their returns.

4. It has to be a back and forth process; **there is no other option if you want to get it right!** And getting it wrong can mean **plan disqualification!**

B. Sole Proprietor with No Rank-and-File Employees

1. Easiest situation.

2. No reductions in earned income due to allocations to employees.

3. Accountant does returns **almost** to completion. Then, gives us:

    a. Bottom Line Schedule C (Line 31- 20 Schedule C)

    b. Details on other income subject to SS taxation (if any).

4. We do our calculations (based on plan formula or maximum, as appropriate) and feed numbers back to accountant.

5. We complete our valuation report after receiving copy of completed Schedule C, Schedule SE, and page 1 of 1040 (at a minimum).

C. Partners only - No Rank-and-File Employees

1. Same as 1 and 2 above.

2. Accountant gives us K-1, line 14 information on each partner, plus (for each partner):

    a. information on any other income subject to SS taxation;

    b. the Section 179 expense (line 12) and how much of it will be deducted on the 1040;

    c. unreimbursed partnership expenses claimed; and

    d. oil and gas depletion claimed.

        (i) These above items can be a BIG problem if the partnership accountant doesn't prepare the personal returns of all the partners;

3. We do our calculations and feed numbers back to accountant.

4. We complete our valuation report after receiving copy of K-1, Schedule SE, page 1 of Form 1065 and page 1 of Form 1040 (at a minimum).

    a. Partner's contributions to plan are shown on line 13 of Form 1065 Schedule K-1 with an IRS code of “R”, and on line 28 of the individual’s Form 1040.

(i) If the payment is to a defined benefit plan, the partnership is supposed to give (*"should give")* the partner a statement showing the amount of the benefit accrued for the current tax year: Lord knows why! What if it doesn't?????

(ii) And of course, you are supposed to give the partner a *specific* amount that is his/her DB *contribution*, even though there is no such thing. That hasn't bothered the IRS since 1976, so I don't expect it will bother them in the future. Best guess appears to be a fine solution.

b. Employees' contributions to the plan are shown on line 18 of Form 1065.

D. Plans Including Rank-and-File Employees

1. Again, the accountant must substantially complete all the tax forms and provide us all the information listed in the examples above (prior to any consideration of contributions to the plan).

2. In addition, we will need the full census information to determine eligibility and covered compensation.

3. The contributions allocated to rank and file employees reduce the Schedule C (or K-1) amounts. Thus, we need to know the rank and file allocation prior to determining the SE tax, the Adjusted Schedule C compensation, and the net earned income. This requirement produces significant circular or interdependent calculations.

4. Where we have a known formula (i.e., a MP plan - as rare as those are) and a sole proprietor, the solution is relatively straight forward. The allocation for rank and file participants is determined and used to reduce the BLC. The Adjusted Schedule C compensation can then be determined and we can solve for the net earned income and self employed contribution by simple algebraic equation. This is true whether the plan is integrated or not.

   a. If we have a PS/401(k) where the rank and file contribution is "known" (such as a 5% gateway contribution for everyone), it may be able to be treated "like" a MP plan, but be careful!

5. In a MP plan with a partnership, we need to also know the partnership provisions for allocating rank and file participant cost (if it's other than on the same basis as the income sharing). Again, we can then solve for each partner's individual contribution and net earned income.

6. In Profit Sharing and 401(k) plans, the complexity increases. Due to the interrelationships of contributions and allocations, we end up with a series of simultaneous equations that do not lend themselves to simple solutions. The application of computer spreadsheet programs such as Excel is one way of dealing with this complexity outside of our commercial software systems.

   When the need to do these calculations was first thrust upon us, our commercial sofware systems were just not programmed for these comples calculations. The significant advancement in the ability of much of our commercial software to handle many aspects of these issues is welcome, At this point, we can depend on our commercial software to produce the results we need in almost every situation.

For example, if the plan is integrated and we want to solve for an optimum contribution based on maximizing a particular partner and there are forfeitures to be handled, we can have an enormously complex model. Add to that top heavy, safe harbor, and weird partnership cost sharing agreements and without the properly robust software, you have a potential nightmare.

(Note: Even a PS plan with a known given contribution still requires complex processing if *any* of the partners participating in the plan are not at the maximum compensation level after the reduction for the contribution amount).

E. Believe it or not; it used to be worse. Anybody remember "family aggregation"?

III. SOLVING THE PROBLEM

In memoriam: over the years, I (and many others) were indebted to Robert Garrels, CPA President of Accountants' Quality Software, Inc. for his Lotus and then Excel template software called AQS Toolkit, which I used extensively over the early years. I was intimately involved in the continual development and enhancement of these templates over the years, to the point where the software ultimately did (almost) everything we needed to get answers quickly.

When Bob passed away in 2006, his son and I reviewed the market and elected to update and provide one more year of the Toolkit software for then current users for 2007. We then expected that the commercial software products should have the process well in hand. Thanks to Bob for his many years of friendship and support of our needs. Toolkit was **invaluable** for many years.

In addition, I am also indebted to Gary Lesser, JD of GSL Galactic Consulting who found my original lecture somewhere and has taken that modest work product and seems to have produced a career out of developing software, materials and books about this issue and the closely related issue of SEPs and SAR-SEPs. Gary has also become a close friend and a frequent ASPPA speaker in past years. Gary is, by my reckoning, now the foremost expert in the world on SEPs and SAR-SEPs. Gary can be located in Indianapolis, Indiana. Phone: (317)254-0385.

Lastly, my partner and friend Derrin Watson, well known to ASPPA members, created some public access Excel sample templates which were published on our now deceased Pension Information eXchange (PIX) website. These templates provided models for many who wanted to develop their own spreadsheets using both the "Iteration" and "Solver" features in Excel (Solver is an add-in).

Today, if you are using any of the commercial software programs that we all know and love (and are many of our vendors and sponsors), you should have all the tools you need to process these calculations, no matter what your specific fact patterns.

Attachments

DETERMINING NET EARNED INCOME FOR SOLE PROPRIETORS AND PARTNERS

SOLE PROPRIETORS

1. Total earned income before **any** plan contributions [Form 1040, Schedule C (line 31 plus line 19)],
2. Less employee allocations [Form 1040, Schedule C, line 19], Line 19 MUST NEVER include any allocation for the self employed individual.
3. Equals the net amount for determining Social Security "in lieu of" deduction [IRC Section 1402(a)(12)] and Social Security tax,
4. Less 1/2 of Social Security Tax [See calculation process next page],
5. Less plan contribution for owner,
6. Equals net earned income for plan purposes.

PARTNERSHIPS

1. Total earned income before **any** plan contributions [Schedule K-1, line 14 + partner's share of employee contributions shown on Form 1065, line 18],
2. Less partner's share of employee allocations [Form 1065, (line 18) (partner's share %)],
3. Less Section 179 expense deduction claimed [See K-1, line 12 and confirm on individual's Form 4562, line 12],
4. Less any unreimbursed partnership expenses claimed [Data from the accountant and/or Form 1040, Schedule E, Part II, Column (h)]
5. Net Amount for determining social security "in lieu of" deduction [IRC 1402(a)(12)] and Social Security tax,
6. Less 1/2 of Social Security Tax [See calculation process next page],
7. Less plan contribution for partner,
8. Equals net earned income for plan purposes.

DETERMINING THE 1/2 OF SOCIAL SECURITY TAX DEDUCTION - 2015

1. If Net Amount for determining social security "in lieu of" deduction is $329,762.77 or higher, then the social security tax deduction (1/2 of the social security tax) will bring the compensation for plan purposes down to $265,000 (or higher). Since $265,000 is the current compensation cap, any amount at this value or higher will simply produce a $265,000 compensation for plan purposes, regardless of the amount of allocation to the self-employed individual.

2. If Net Amount for determining social security "in lieu of" deduction is above $128,316.19 and below $329,762.77 then use the following formula to determine 1/2 of the social security tax:

   [7347.00 + (.01339075)(Net Amount)] = 1/2 of the SS tax

   (subtract this amount from the Net Amount to get Compensation after SS reduction)

3. If Net Amount for determining social security "in lieu of" deduction is at or below $128,316.19, then the following formula directly results in the Net Amount - 1/2 of the SS tax:

   (.92935225) (Net Amount) = Compensation after SS reduction

NOTE: These calculations assume that there is no other income subject to social security taxation for the sole proprietors or partners. If this is not the case, the calculation process above must be adjusted accordingly.

These rules can be adjusted for years after 2015 by following the explanation of the derivation of the numbers in the text of the outline.

This chart was provided by Gary Lesser, author of the *SIMPLE, SEP, and SARSEP Answer Book*. Gary maintains a consulting practice providing custom retirement plan illustrations for smaller plans, EPCRS and VFCP applications and related spreadsheets, and other services to other professionals and business owners. Phone: (317) 254-0385.

Following is a worksheet for calculating "ultra net" earned income under Code Section 401(c)(2) for purposes of allocating contributions and calculating the employer's deduction and the amount of contributions that may be excluded from the employee's gross income (adjusted through 2016).

1.	Total earned income before any plan contributions (for 2016, Schedule K-1, line 14, code A, plus partner's share of nonowner-employee contributions shown on Form 1065, line 18)	$ ____________
2.	Less any unreimbursed partnership expense claimed (data from the accountant or Form 1040, Schedule E, Part II, line 28, column (h))	!$ ___________
3.	Less Section 179 expense deduction claimed (see Schedule K-1, line 12, and confirm on Form 4562, line 12)	!$ ___________
4.	Less depletion claimed on oil and gas properties (see Schedule SE, Instructions, Partnership Income or Loss)	!$ ___________
5.	**Pre-plan compensation (items 1–4): Sole Proprietorships, start here.**	=$ ___________
6.	Less owner's share of common-law employee allocations (Form 1065, line 18, multiplied by partner's share percentage, or line 19 from Schedule C if self-employed)	!$ ___________
7.	**Net amount** for determining ½ of the self-employment tax deduction under Code Section 164(f) (Items 5 and 6)	=$ ___________
8.	Less half of self-employment tax deduction (if individual also has W-2 income, complete long Schedule SE to reflect the proper SE tax and *in lieu of* deduction)	!$ ___________
9.	Less elective and nonelective contributions for owner	!$ ___________
10.	**Earned income** for SEP exclusion purposes (Items 7-9; up to $265,000 for plan years beginning in 2016)	=$ ___________
11.	Plus elective contributions of owner*	+$ ___________
12.	**Earned income** for deduction purposes (not to exceed $265,000)	=$ ___________
13.	**Earned income** for the allocation of plan contributions (Items 10 and 11 up to $265,000 for plan years beginning in 2016)*	=$ ___________

*Not all plans provide for elective contributions to be included in the definition of earned income for the purpose of allocating employer contributions. For contribution allocation purposes after 1997, compensation generally may include elective contributions.

Line and box numbers from the 2016 tax forms are used in this chart

IRC §401(c): Definitions and rules relating to self-employed individuals and owner-employees.

For purposes of this section ---

(1) Self-employed individual treated as employee.

(A) In general. The term "employee" includes, for any taxable year, an individual who is a self-employed individual for such taxable year.

(B) Self-employed individual. The term "self-employed individual" means, with respect to any taxable year, an individual who has earned income (as defined in paragraph (2)) for such taxable year. To the extent provided in regulations prescribed by the Secretary, such term also includes, for any taxable year --

(i) an individual who would be a self-employed individual within the meaning of the preceding sentence but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(ii) an individual who has been a self-employed individual within the meaning of the preceding sentence for any prior taxable year.

(2) Earned income.

(A) In general - The term "earned income" means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined --

(i) only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor,

(ii) without regard to paragraphs (4) and (5) of section 1402(c),

(iii) in the case of any individual who is treated as an employee under sections 3121(d)(3)(A), (C), or (D), without regard to paragraph (2) of section 1402(c),

(iv) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items,

(v) with regard to the deductions allowed by section 404 to the taxpayer, and

(vi) with regard to the deduction allowed to the taxpayer by section 164(f).

For purposes of this subparagraph, section 1402, as in effect for a taxable year ending on December 31, 1962, shall be treated as having been in effect for all taxable years ending before such date.

(B) Repealed.

(C) Income from disposition of certain property. For purposes of this section, the term "earned income" includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property.

IRC §164(f) Deduction for one-half of self-employment taxes.

(1) In general - In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 for such taxable year.

(2) Deduction treated as attributable to trade or business - For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

IRC §1401 RATE OF TAX.

(a) Old-age, survivors, and disability insurance. In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to the following percent of the amount of the self-employment income for such taxable year:

In the case of a taxable year Beginning after:	And before:	Percent:
December 31, 1983...	January 1, 1988.....	11.40
December 31, 1987...	January 1, 1990.....	12.12
December 31, 1989.................................		12.40

(b) Hospital insurance. In addition to the tax imposed by the preceding subsection, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to the following percent of the amount of the self-employment income for such taxable year:

In the case of a taxable year Beginning after:	And before:	Percent:
December 31, 1983...	January 1, 1985.....	2.60
December 31, 1984...	January 1, 1986.....	2.70
December 31, 1985.................................		2.90

(c) Relief from taxes in cases covered by certain international agreements. During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, the self-employment income of an individual shall be exempt from the taxes imposed by this section to the extent that such self-employment income is subject under such agreement to taxes or contributions for similar purposes under the social security system of such foreign country.

IRC §1402 DEFINITIONS.

(a) Net earnings from self-employment. The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss --

....

(12) in lieu of the deduction provided by section 164(f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction equal to the product of --

(A) the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph), and

(B) one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year;

EXAMPLES

Sole-Proprietor / Partnership Calculation Report

Plan ID: 1422
Post Date: 9/12/2016 1:40:04 PM
Effective Date: 12/31/2015
Transaction ID: 115
Salaries have been computed for the following people. These salaries have been entered into Census data on the Computed
Compensation screen. If you wish these salaries to appear in payroll, you should enter these values into the payroll period
where you wish them to appear.

Name	Partner Ratio	Partner Share of Gross Profit	Pension Cost Ratio	Pension Cost Share of Rank & File	Outside W-2 Income	FICA	Current Contrib.	Prior Contrib.	Payroll Compensation	Gross Compensation	Adjusted Compensation
Robert	100.000000	106339.00	100.000000	3006.96	0.00	7300.18	2797.04	0.00	0.00	93234.82	93234.82

3% Safe Harbor Contribution Only

ROBERT
401(K) PLAN AND TRUST
Contribution Analysis Report
From 1/01/2015 to 12/31/2015

9/12/2016

Soc Sec Number	Employee Name	Deferrals	Employer Contrib	Total Contrib
***-**-6721	ROBERT	24,000.00	2,797.04	26,797.04
***-**-7300	C	0.00	789.51	789.51
***-**-7477	J	0.00	1,091.40	1,091.40
***-**-1982	G	2,650.00	1,126.05	3,776.05
Grand Total:		26,650.00	5,804.00	32,454.00

Sole-Proprietor / Partnership Calculation Report

Plan ID: 1422

Post Date: 9/12/2016 1:43:05 PM

Effective Date: 12/31/2015

Transaction ID: 115

Salaries have been computed for the following people. These salaries have been entered into Census data on the Computed Compensation screen. If you wish these salaries to appear in payroll, you should enter these values into the payroll period

where you wish them to appear.

Name	Partner Ratio	Partner Share of Gross Profit	Pension Cost Ratio	Pension Cost Share of Rank & File	Outside W-2 Income	FICA	Current Contrib.	Prior Contrib.	Payroll Compensation	Gross Compensation	Adjusted Compensation
Robert	100.000000	106339.00	100.000000	25058.00	0.00	5742.32	15107.74	0.00	0.00	60430.95	60430.95

Maximum 25% Contribution

ROBERT

401(K) PLAN AND TRUST

Contribution Analysis Report

From 1/01/2015 to 12/31/2015

9/12/2016

Soc Sec Number	Employee Name	Deferrals	Employer Contrib	Total Contrib
***-**-6721	ROBERT	24,000.00	15,107.74	39,107.74
***-**-7300	C	0.00	6,579.25	6,579.25
***-**-7477	J.	0.00	9,095.00	9,095.00
***-**-1982	G	2,650.00	9,383.75	12,033.75
Grand Total:		26,650.00	40,165.74	66,815.74

STARR

Sole-Proprietor / Partnership Calculation Report

Plan ID: 2743
Post Date: 9/27/2016 2:25:58 PM
Effective Date: 12/31/2016
Transaction ID: 2

Salaries have been computed for the following people. These salaries have been entered into Census data on the Computed Compensation screen. If you wish these salaries to appear in payroll, you should enter these values into the payroll period where you wish them to appear.

Name	Partner Ratio	Partner Share of Gross Profit	Pension Cost Ratio	Pension Cost Share of Rank & File	Outside W-2 Income	FICA	Current Contrib.	Prior Contrib.	Payroll Compensation	Gross Compensation	Adjusted Compensation
Owner, O.	44.131000	242499.85	44.131000	4169.13	0.00	10538.43	25505.62	0.00	0.00	202286.67	202286.67
Owner, T.	32.757000	179999.71	32.757000	3094.60	0.00	9715.89	17537.09	0.00	0.00	149652.13	149652.13
Owner, T.	23.112000	127000.44	23.112000	2183.43	44000.00	6290.39	11138.58	0.00	0.00	107388.03	107388.03

	Partner Ratio	Partner Share of Gross Profit	Pension Cost Ratio	Pension Cost Share of Rank & File	Outside W-2 Income	FICA	Current Contrib.	Prior Contrib.	Payroll Compensation	Gross Compensation	Adjusted Compensation
Totals:	100.000000	549500.00	100.000000	9447.16	44000.00	26544.71	54181.29	0.00	0.00	459326.83	459326.83

Earned Income Example
401(k) Plan
Contribution Analysis Report
From 1/01/2016 to 12/31/2016

9/27/2016

Soc Sec Number	Employee Name	Comp.	Deferrals	Employer Contrib	Total Contrib
***-**-1082	Employee, One	25,000	0.00	3,408.77	3,408.77
***-**-1083	Employee, Two	62,000	600.00	6,038.39	6,638.39
***-**-1079	Owner, One		18,000.00	25,505.62	43,505.62
***-**-1081	Owner, Three		18,000.00	11,138.58	29,138.58
***-**-1080	Owner, Two		18,000.00	17,537.09	35,537.09
Grand Total:			54,600.00	63,628.45	118,228.45

R&F Allocation: 3% Safe Harbor plus
6.73934% = 9.739%

Formula: 5.4% excess over 80% TWB

1.4