

Understanding K-1 Income in Retirement Plan Design

A frequent and complex challenge for retirement plan advisors can be properly defining compensation for plan eligibility and contribution purposes, including income reported on a Schedule K-1. Improper reporting of K-1 income may result in compliance errors, contribution miscalculations, and/or plan disqualification.

What is K-1 Compensation? Owners of partnerships and LLCs taxed as partnerships typically receive income reported on a K-1, rather than wages reported on Form W-2. This means that unlike employees, these owners do not receive traditional salaries with FICA withholding; instead, they receive “earned income,” which is derived from their distributive share of profits and guaranteed payments for services. S-corporation shareholders might also receive K-1 income, in addition to W-2 wages.

As advisors, it is important to understand that not all K-1 income counts as plan compensation. For partners, plan compensation is “earned income,” i.e., net earnings from self-employment, which is generally the partner’s share of the trade or business income and guaranteed payments for services to the extent they are subject to self-employment taxes. Passive income, investment returns, or distributions not tied to related services are generally excluded.

Why it Matters for Retirement Plans: Contribution limits, non-discrimination testing, and plan allocations all depend on clear and correct definitions of plan compensation. For example:

- **Partnerships and LLCs:** Contributions for partners are based on earned income after deducting plan contributions and one-half of self-employment taxes.

- **S-corporations:** Only W-2 wages count as plan compensation; K-1 distributions to shareholders do not.

- **Guaranteed Payments:** Guaranteed payments for services generally qualify as plan compensation.

Failing to distinguish between eligible K-1 income and other partnership allocations can inflate or understate allowable contributions, and result in issues for plan sponsors.

Key Takeaways for Plan Advisors: For business owners with K-1 income, understanding plan compensation is not always straightforward. As plan advisors, you can assist your clients by identifying the type of entity they own, clarifying the nature of their K-1 income, and ensuring plan documents clearly define compensation. Be sure to coordinate with your TPA and CPA partners to ensure plan compliance, cross-check calculations and make any necessary tax adjustments.

Reminders:

- October 15, 2025: For calendar-year plans, deadline to adopt and implement a corrective amendment to correct a Code Section 410(b) coverage failure or a Code Section 401(a)(4) nondiscrimination failure for the 2024 plan year.
- October 15, 2025: Deadline to file Form 5500 (plan years ended December 31), for those plans that previously filed a Form 5558 extension request.

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