

IRS Summarizes Tax Consequences of Excess Deferrals, Providing Insights for Plan Sponsors and Participants

EBIA Weekly (November 14, 2024)

IRS Issue Snapshot — Consequences to a participant who makes excess deferrals to a 401(k) plan

Available at

<https://www.irs.gov/retirement-plans/consequences-to-a-participant-who-makes-excess-deferrals-to-a-401k-plan>

The IRS has released an “Issue Snapshot” that summarizes rules applicable to excess deferrals made to a 401(k) plan. Generally, elective deferrals that exceed the Code’s annual deferral limit are called “excess deferrals” (e.g., a participant aged 35 who defers \$24,000 in 2025, when the deferral limit is \$23,500, has an excess deferral of \$500). Excess deferrals may result in increased income tax liability to participants and possible plan disqualification if not corrected.

Unless timely distributed, excess deferrals are included in a participant’s taxable income for the year they were initially contributed and are taxed again when ultimately distributed from the plan. [EBIA Comment: The distribution may also be subject to the additional 10% penalty tax on early distributions, if applicable.] The amount of the excess deferral will not be subject to double taxation if a corrective distribution is timely made. Corrective action involves returning the excess deferrals with any earnings attributable to the calendar year the excess deferrals were made, but not earnings attributable to the period between the close of that calendar year and the actual date of distribution. Additionally, the corrective distribution must be made no later than April 15 of the year following the calendar year in which excess deferrals were made. The IRS does not extend this April 15 deadline even if the employee extends their federal income tax return filing date. If the plan offers catch-up contributions and the participant is eligible to make them, deferral amounts that exceed the Code’s annual deferral limit will not be treated as excess deferrals to the extent that the amounts are within the applicable catch-up contribution limit for the year.

The Issue Snapshot includes audit tips that reflect elements of reviewing a plan for excess deferrals, such as determining if the plan sponsor is a member of an affiliated service or a controlled group to determine if employees can participate in more than one plan. The IRS also recommends inspecting the plan document to determine the maximum elective deferrals participants can make, including catch-up contributions, and inspecting payroll and tax reporting records to ensure each participant complies with the annual deferral limit in effect for the year. Other recommendations include comparing Forms W-2 (Box 12—code “D” for elective deferrals or “AA” for designated Roth contributions) with payroll records and account statements to reconcile the reported deferral amounts and ensure their accuracy and, after testing for excess deferrals, ensuring that any excesses were properly and timely corrected by April 15 of the following calendar year.

Although not discussed in detail, the Issue Snapshot notes that 401(k) plans also may have operational issues that subject them to disqualification where they fail to follow plan terms prohibiting employee elective deferrals from exceeding the applicable annual deferral limit. [EBIA Comment: Plans should use the IRS's Employee Plans Compliance Resolution System to correct the failure.

EBIA Comment: Issue Snapshots are documents created for use by IRS employees that analyze tax issues, provide examples of how the law works in operation, and provide references to additional resources, including Code sections and regulations, revenue rulings, and legislation. Issue Snapshots are not intended as a comprehensive discussion of all issues on a covered topic, and they do not limit the IRS's ability to use other approaches in examinations. Nevertheless, 401(k) plan sponsors, administrators, and advisors may find them to be a helpful resource. For more information on excess deferrals, see EBIA's 401(k) Plans manual at Sections VIII.M ("Correcting Excess Deferrals"), X.C ("Limitations on Deferrals: Elective, Roth, and Catch-Up"), XXI.J ("Corrective Distributions: Other Issues"), XXXIV.G ("Errors Involving Contributions"), XXXIV.M ("Errors Involving Plan Documents"), and XXXV ("Correcting Plan Mistakes: IRS's EPCRS").

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