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Correcting 401(k) Plan Excess Elective Deferrals

by Lisa S. Boehm on February 22, 2022

With the April 15 deadline for distributing excess elective deferrals fast approaching, this post summarizes the rules for correcting excess elective deferrals made to a 401(k) plan. In brief, excess elective deferrals not distributed from a 401(k) plan by April 15 of the calendar year following the calendar year in which they were contributed will be taxed twice and may be subject to an additional 10% tax on early distributions. In addition, excess elective deferrals arising solely under a single employer's 401(k) plan that are not corrected by the April 15 deadline put the tax qualified status of the plan at risk.

Legal Limits on Elective Deferrals

Section 402(g) of the Internal Revenue Code of 1986, as amended ("Code") limits the amount of elective deferrals a plan participant may exclude from gross income each calendar year. Elective deferrals include both pre-tax elective deferrals and designated Roth elective deferrals, which are elective deferrals that are made on an after-tax basis. The Code Section 402(g) limit applies to elective deferrals made under various types of retirement plans, including 401(k) plans, 403(b) plans, and salary reduction SEPs. In applying the limit, an individual must aggregate all elective deferrals made to all plans in which he or she participates. If the aggregated elective deferrals exceed the Code Section 402(g) limit in effect for a calendar year, the excess elective deferrals are included in the individual's gross income for such year and, if not timely corrected (as explained below), will also be included in the individual's gross income for the calendar year in which they are distributed from the plan (*i.e.*, the excess elective deferrals will be subject to double taxation).

For 2022, the Code Section 402(g) limit is $20,500 for individuals who will not have attained age 50 by December 31, 2022, and $27,000 for individuals who will be age 50 or older by December 31, 2022 ($20,500 + $6,500, which is the limit on catch-up contributions for 2022). Plans may (but are not required to) permit catch-up contributions.

Code Section 401(a)(30) provides that a plan will not constitute a qualified plan for income tax purposes unless it provides that the amount of elective deferrals, other than catch-up contributions, made under the plan and all other plans maintained by the same employer[1] during a calendar year may not exceed the limit for that year under Code Section 402(g)(1)(A) ($20,500 for 2022).

Tax Treatment of Excess Elective Deferrals

Unless they are timely distributed, excess elective deferrals are in included in a participant's gross income for the year in which they were made to a plan, and for the year in which they are distributed from the plan. A distribution of excess elective deferrals is reported on IRS Form 1099-R (not on Form W-2 or a corrected Form W-2).

Excess Elective Deferrals Distributed by April 15. If excess elective deferrals are distributed from a plan by April 15 of the calendar year following the calendar year in which they were made to the plan, they are included in the participant's gross income for the year in which they were made, but not included, again, for the calendar year in which distributed (if different from the year in which they were made). The corrective distribution must include any earnings on the excess elective deferrals through the end of the calendar year in which the excess elective deferrals were made and must be included in the participant's gross income for the calendar year in which they are distributed. The entire corrective distribution is not subject to the additional 10% tax on early distributions under Code Section 72(t).

Excess Elective Deferrals Distributed after April 15. If the excess elective deferrals (and any allocable earnings through the end of the calendar year in which the deferrals were made) are not distributed from the plan by April 15 of the calendar year following the calendar year in which they were made, the excess elective deferrals will be included in the participant's gross income twice - - in the calendar year of deferral and a second time in the calendar year of distribution from the plan. (Note, any distribution of excess elective deferrals attributable to designated Roth elective deferrals will have already been included in the participant's gross income in the calendar year of deferral.) The reason for this "taxed twice" consequence is that where the corrective distribution is not made by the April 15 deadline, the excess elective deferral, which is taxable in the calendar year of deferral, is not included in the participant's cost basis for purposes of determining the taxable amount of the eventual distribution from the plan. Distribution of excess elective deferrals made after the April 15 deadline also may be subject to the additional 10% tax on early distributions under Code Section 72(t).

Potential Plan Disqualification arising from Failure to Distribute Excess Elective Deferrals by April 15. In addition, if the excess elective deferrals are not corrected by the April 15 deadline and they contravene Code Section 401(a)(30) (*i.e.*, the excess elective deferrals arise solely under the employer's 401(k) plan and not as a result of any elective deferrals made by the participant to an unrelated employer's plan during the calendar year), there are adverse tax consequences not only to the participant (as described in the preceding paragraph), but also to the employer and its 401(k) plan. If the excess elective deferrals contravene Code Section 401(a)(30) and remain in the employer's 401(k) plan after the April 15 deadline, the 401(k) plan is subject to disqualification. To eliminate the risk of plan disqualification, the employer must use the IRS Employee Plans Compliance Resolution System ("EPCRS") to correct the failure to follow the terms of the plan regarding compliance with Code Section 401(a)(30).

One last wrinkle to note that drives home the importance of correcting excess elective deferrals by the April 15 deadline. Unless the excess elective deferrals contravene Code Section 401(a)(30), EPCRS is not available to make a corrective distribution after the April 15 deadline, and, pursuant to the regulations under Code Section 402(g), the excess elective deferrals may only be distributed when otherwise permitted under the terms of the 401(k) plan (*e.g.*, the participant's termination of employment or attainment of age 59½).

Examples

Example #1: Employee X is 40 years old and for 2021 she deferred $20,000 to her employer's 401(k) plan (which is the only plan in which she participated for 2021). None of the elective deferrals were designated Roth elective deferrals. Employee X has excess elective deferrals of $500 because $19,500 is the Code Section 402(g) limit for 2021 for individuals under age 50. The allocable earnings on the excess elective deferrals through December 31, 2022 is $25.

- If the excess elective deferrals (and allocable earnings) were distributed from the 401(k) plan to Employee X on or before December 31, 2021, Employee X must include $500 plus the allocable earnings through the date of distribution in gross income for 2021.
- If the $525 is distributed from the 401(k) plan to Employee X between January 1, 2022 and April 15, 2022, Employee X must include $500 in gross income for 2021 and $25 in gross income for 2022.
- If the $525 is distributed from the 401(k) plan to Employee X after April 15, 2022, Employee X must include $500 in gross income for 2021, and $525 in gross income for the calendar year in which the distribution is made. In addition, Employee X will be subject to the Code Section 72(t) additional 10% tax on early distributions if an exception to that tax does not apply. Note, because the excess elective deferrals (and allocable earnings) were not distributed by April 15, 2022, the employer must use EPCRS to correct the failure to comply with Code Section 401(a)(30).

Example #2: Same facts as Example #1, except Employee X worked for two unrelated employers during 2021 and deferred $15,000 under one employer's 401(k) plan and $5,000 under the other employer's 401(k) plan. Because Employee X's elective deferrals did not exceed the Code Section 402(g) limit for 2021 under either plan, neither plan violated Code Section 401(a)(30). Employee X, however, must choose which 401(k) plan will make the corrective distribution of $525 (the $500 excess elective deferral + $25 allocable earnings).

The first two bullet points are the same as in Example #1. If, however, the corrective distribution is not made on or before April 15, 2022, while the tax consequences for Employee X are the same as the third bullet under Example 1, the distribution is not allowed to be made from the 401(k) plan Employee X chose to make the distribution until Employee X is otherwise permitted to receive a distribution from that plan. In short, Employee X must include the $500 excess elective deferral in gross income for 2021, but the $525 must stay in the 401(k) plan until Employee X has a distributable event (*e.g.*, termination of employment or attainment of age 59½). If Employee X terminates employment and receives distribution of her entire vested 401(k) plan account balance in 2030, for example, she must include the $525 in gross income for 2030, and this amount will not be eligible for rollover and may be subject to the Code Section 72(t) additional 10% tax on early distributions if an exception to that tax does not apply.

Two final points about Example #2. First, it would be prudent for the plan administrator of the plan making the distribution to obtain sufficient documentation from Employee X for the 2021 excess deferral amount before making a distribution (*e.g.*, a copy of an account statement from the other employer's 401(k) plan showing the amount of Employee X's elective deferrals under that plan for 2021 or a copy of Employee X's 2021 Form W-2 from the other employer showing the amount of Employee X's elective deferrals to document the excess deferral amount and ensure proper reporting on IRS Form 1099-R). Second, if Employee X were a catch-up eligible participant, the regulations under Code Section 402(g) would permit Employee X to exclude the $500 from Employee X's gross income for 2021, even if neither plan treats those elective deferrals as catch-up contributions.

Please contact a member of our Employee Benefits & Executive Compensation Group if you have any questions about correcting excess elective deferrals.

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[1] The controlled group and affiliated service group rules apply in determining whether an employer is "the same" employer.

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