

Plan Sponsors: The Why, How, and When of Retirement Plan Limits

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The Why

Most plan sponsors don't think too much about the contribution limits that apply to retirement plans such as 401(k), 403(b), IRAs, and other such plans. These plans receive favorable tax treatment, so Congress has applied limits to prevent abuse by the extremely wealthy. The limits vary based on the type of plan and change almost every year.

The consequences of exceeding these limits differ based on the type of plan involved. Defined contribution plans (401k and 403b) tax excess deferrals (contributions above the limit) by including the excess in the contributor's gross income the year it is contributed. These contributions can also be taxed when those contributions are withdrawn, resulting in being taxed twice!

While not an employer plan, IRAs also have limits. However, the IRA penalties are much more severe – a 6% excise tax on the excess IRA contributions for each year the funds remain in the IRA capped at 6% of the total account value per year. This may also come into play if the employee contributes to a Roth IRA but is above the income limits for Roth treatment.

If the employer contributes more than the deductible limit, a 10% excise tax applies to the nondeductible amount, payable by the employer. If a 401(k) plan fails nondiscrimination testing, which compares the benefits received by Highly Compensated Employees to other employees, the limits are effectively reduced, resulting in excess contributions subject to the 10% employer excise tax.

If the deferral limit is not followed or remains uncorrected, the plan's tax-qualification is put at risk. The loss of tax-qualification results in all contributions to the plan becoming immediately taxable in addition to other penalties as determined by the IRS in its examination.

Of course, the IRS has established corrective procedures, but they can be time-consuming and costly. It is far easier to prevent the error than to attempt to correct it after the fact. It is especially desirable to avoid the necessity of correction through the Employee Plans Compliance Resolution System (EPCRS), which has different correction paths up to and including negotiation with the IRS on a per violation basis.

The How

These limits were not fixed in dollar terms but are subject to cost-of-living increases which adjust them to account for inflation. Adding complexity is that the limits only increase in round numbers, typically \$500, \$1,000, or \$5,000 increments. Keep in mind that these limits apply to the individual and the company as a whole. That is, the individual has their own contribution limit across all plans. Likewise, if the company maintains more than one defined contribution plan, the employer limit applies across all of its DC plans.

Every year the IRS determines the cost-of-living changes to the limits and publishes them on the IRS website (www.irs.gov) as a notice on both the main page and its retirement plan pages. The notices go into detail on the calculations performed but that is beyond the scope of this note. The notices will provide for increases based on each plan and contribution type. For example, deferral limits will increase in \$500 increments, with plan-level limits increasing in either \$1,000 or \$5,000 increments. These limits will be combined with any “catch-up” limits to determine the total annual limit for each contributor.

If you administer your own plan, develop a system to track employee contributions to eliminate the possibility of excess contributions – or at the least be able to track employee contributions against the limit for timely correction.

The When

There are a couple of different deadlines or timeframes to consider.

Annual limit notices are typically published in the fall of the prior year. That is, the limits for calendar year 2027 will be published in the fall of 2026. This provides plenty of time to provide notice to employees and service providers as well as calculate any “catch-up” contributions.

Excess salary deferrals must be corrected by April 15th for the previous plan year. Testing failures have a correction deadline of 2 ½ months after year end. Testing failures can be particularly difficult to catch in a timely manner. It is advised to work with your plan service providers to test for projected plan testing in Q4 of each year, which provides enough time to make changes to prevent testing failure.

Conclusion

Not paying attention to plan contribution limits can result in taxes and expensive corrections at the best, and plan disqualification at worst. Make a point to check the limits each fall and coordinate with your Administrator to implement any updates as well as provide notice of the changes to your employees.



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