JANUARY 21, 2022

Check W-2, Box 12 Code D to ensure 401(k) compliance

There are no tax penalties for incorrectly coding items reported in Box 12 of your W-2s. *Phew!* But you're not walking away scot-free. The IRS uses those codes to determine compliance with other sections of the tax code, like 401(k) compliance and teasing out employees who earn too much to make tax-deductible IRA contributions.

W-2 coding for 401(k) contributions

Code D, along with the total amount of an employee's pretax contributions into a 401(k) plan, is entered in Box 12. To report $4,000 in pretax 401(k) contributions made last year, enter the following in Box 12: D 4000.00. The total amount reported with Code D includes amounts exceeding the pretax contribution limit.

Example: Sally deferred $21,500 into her 401(k) account last year, when the maximum pretax contribution was $19,500. Her Box 12 coding looks like this: D 21500.00. The $2,000 excess contribution isn't reported in Box 1 of Sally's 2021 W-2. Instead, the $2,000, along with earnings, is returned to her and reported on Form 1099-R. Sally's employer has until April 15, 2022, to do this.

Employees who are 50+ can contribute make-up amounts into their 401(k) plans, also on a pretax basis. Use Code D to report 401(k) make-up pretax contributions. To report $4,000 in pretax contributions, plus $2,000 in pretax make-up contributions, made last year: D 6000.00.

Finally, employees who couldn't contribute to their 401(k) plans because they were away on military service can make make-up contributions on a pretax basis. To report make-up contributions attributable to 2019 and 2020: D 19 2250.00, D 20 1250.00. Here, including the two-digit year is crucial.

How IRS employee plan auditors use Code D

Code D contains a treasure trove of information for IRS employee plan auditors.

At the outset, 401(k) auditors review your W-2s and your payroll records to verify that employees' pretax contributions weren't designated or treated as after-tax contributions.

After the pre-tax/after-tax determination, auditors next compare the Code D amounts to your payroll records and account statements to reconcile the amounts reported and ensure they're accurate. If an employee, like Sally above, overcontributed into their 401(k) account, auditors determine whether you properly and timely corrected the excess contributions. Auditors inspect Forms 1099-R for distributions and canceled checks to determine when the distribution was actually made.

If you have an individually designed 401(k) plan (i.e., you're not using a safe harbor plan) you must ensure it doesn't discriminate in favor of highly compensated employees. The IRS has developed two tests, the ADP test (actual deferral percentage) and the ACP test (actual contribution percentage) for this purpose. The Code D amounts feed into the ADP test.

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Finally, auditors use W-2 information to determine whether employees' total 401(k) contributions—pretax, after-tax, and employer matching contributions—exceed the IRC § 415 limitations (i.e., the lesser of 100% of an employee's compensation or $58,000 for 2021).

Remember Sally?

And then there's Sally, who overcontributed to her 401(k) plan last year. The IRS matches employees' Forms 1040s, W-2s, and 5498. If Sally also contributed to a tax-deductible IRA last year, the overcontribution may raise a red flag for the IRS. And while it's true the IRS is suffering from some substantial performance issues, its automated notice programs aren't suffering similarly.

Before you file your 2021 W-2s

You can take the following steps now to ensure your 2021 W-2s are coded correctly:

- Review W-2s and payroll records to confirm employees' pretax contributions weren't designated or treated as after-tax employee contributions.
- Balance and reconcile all amounts reported in Box 12 with Code D before entering the result in Box 12a of Form W-3.
- Match payroll records and your HR records for purposes of determining whether employees are qualified to make make-up contributions.

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