Compensation for 401(k) deferrals

Which pay counts for 401(k) deferrals, and the rules that most often trip up plan sponsors.

- S corporation owners need W-2 wages to participate: K-1 pass-through income doesn't count
- Deferral elections apply only to future pay, never to a paycheck already received
- Bonuses count unless the plan document excludes them, and any exclusion must pass a 414(s) test
- Compensation counted for 2026 is capped at $360,000

WHO	COMPENSATION FOR THE PLAN
Employees of a corporation	**W-2 wages**
S corporation owners	**W-2 wages only**
Sole proprietors	**Net Schedule C earnings**
Partners	**Schedule K-1 earnings**

Self-employed earnings usually aren't final until the tax return is prepared, so deposit deferrals with care. Many compensation errors can be self-corrected under the IRS EPCRS program if they're caught early.

QUESTIONS ABOUT A PLAN? CONTACT US.

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Compensation for 401(k) deferrals

A plan's definition of compensation decides what each person can defer and how employer contributions are figured. Compensation errors are among the most common compliance problems in qualified plans, and most can be avoided by reading the plan document closely.

What a 401(k) deferral is

A 401(k) plan lets eligible employees choose to have part of their pay put into the plan instead of receiving it in cash. These elective deferrals can be pretax or Roth, and they're reported each year on the employee's W-2.

The name comes from Section 401(k) of the Internal Revenue Code, which set the rules that let employees make pretax salary deferrals through an employer's plan.

Whose pay counts

Employees of the business can defer once they're eligible. In a corporation, or an entity taxed as one (an S corp, a C corp, or an LLC or PLLC taxed as a corporation), employees are paid W-2 wages, and those wages are their compensation.

Self-employed people don't receive a W-2. That includes sole proprietors, partners, and owners of LLCs and LLPs taxed as a sole proprietorship or partnership. Their compensation for plan purposes is self-employment earnings, reported on Schedule C for a sole proprietor or on a Schedule K-1 from Form 1065 for a partner.

S corporation owners need W-2 wages

An S corporation owner can't use K-1 income for the plan. That income passes through the business and isn't self-employment earnings. To participate, the owner must be paid W-2 wages.

Deferrals start with an election

Internal Revenue Code section 401(k)(2)(A) requires an employee to elect a deferral in place of cash. The employer then deposits it in the plan's trust account as soon as administratively feasible after each pay period.

Elections apply only to future pay. Under Treasury Regulation 1.401(k)-1(a)(3)(iii)(B), a contribution can't come before the election, so an employee can't go back and defer from a paycheck already received.

A plan can also use automatic enrollment, which defers a set percentage of pay for each eligible employee unless they opt out.

The compensation limit

IRC 401(a)(17) caps the pay a plan can count each year. For 2026, the limit is $360,000. The IRS adjusts it periodically for cost of living, usually announcing changes each year, and new limits take effect on January 1.

Bonuses and other irregular pay

Bonuses and other irregular pay count as compensation unless the plan excludes them. A plan can exclude some types of pay, but the exclusion has to pass a nondiscrimination test under IRC 414(s), and it must be written into the plan document.

Bonuses cause more confusion than any other kind of pay. Whether employees can defer from a bonus depends on what the plan document says.

Sole proprietors and partners

Self-employed people can make deferrals, but their compensation is earned income from Schedule C or Schedule K-1, which usually isn't final until the tax return is prepared after the plan year ends.

They should work with their CPA or tax advisor and take care with deferral deposits during the year, so there are enough self-employment earnings to support them.

When something goes wrong

Applying the plan's definition of compensation incorrectly leads to wrong contributions. That's an operational failure, and the plan has to correct it to keep its qualified status.

Caught early, many compensation errors can be self-corrected under the IRS Employee Plans Compliance Resolution System (EPCRS), which keeps the cost and paperwork down. Prime can help work out the correction.

The best protection is to read the plan document before an error happens, and know how it defines compensation for contributions, nondiscrimination testing and deductions.

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