TAX CREDIT FOR SMALL EMPLOYER START-UP PLANS

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Many employers are unaware that, in certain circumstances, they may be eligible for a valuable tax credit in connection with their establishment of a retirement plan. Although this particular tax credit has been available for almost two decades, it is still surprising to see the general lack of awareness that most plan sponsors have regarding this tax saving opportunity. As a result, this article is intended to familiarize readers with this tax credit so that they can attempt to evaluate its application to their (or their client's) tax situation.

Effective for tax years beginning on or after January 1, 2002, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[1] created a tax credit for "small employers" who establish a new "eligible employer plan". The credit is equal to up to 50 percent of the "qualified plan start-up costs" incurred for a period of up to three years. In addition, a $500 maximum limit applies in relation to the credit for each of the three years that the credit may be claimed.

Recently, the Setting Up Every Community for Retirement Enhancement ("SECURE") Act increased the original limits discussed above for tax years beginning after December 31, 2019. The revised value of the credit is now equal to up to 50 percent of qualified plan start-up cost for each of the first three years of the plan's existence up to the greater of: 1) $500; or 2) the lesser of a) $250 per eligible non highly compensated employee; or b) $5,000. As a result of this change, the potential tax credit has substantially increased from a potential maximum of $500 per tax year to a potential maximum credit of $5,000 per year.

An employer may elect to initially apply the credit to the year the permissible plan is established or to the year before establishment. Also, the employer may not deduct any start-up costs if it claims the credit.

As you can see, there are several very important "defined terms" included within the authorizing language for the credit that are critical to determining its availability to any particular plan sponsor. First of all, only a "small employer" is eligible to claim this tax credit. In this context, a small employer is defined in the same manner as it is used in conjunction with SIMPLE plans. Thus, in general, a small employer for purposes of this tax credit is an employer with 100 or fewer employees who received at least $5,000 of compensation from such employer for the preceding year.

[1] Although the authorization for this tax credit under EGTRRA was scheduled to expire at the end of 2010, it was instead extended and made permanent by the Pension Protection Act of 2006 ("PPA").

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Another important consideration is that the start-up credit is only available with respect to the establishment of an “eligible employer plan”. In general, an eligible employer plan is a tax-qualified plan under section 401(a) of the Code (such as a profit sharing plan, 401(k) plan and/or defined benefit plan, among others), Simplified Employee Pension Plan (“SEP”) or Savings Incentive Match Plan for Employees (“SIMPLE”). In addition, in order to qualify for the credit, the newly established plan must have at least one participating non-highly compensated employee. This final “eligible plan” qualification is of great importance because it effectively eliminates the credit with regard to “solo(k)” plans.

Finally, the credit may only be applied in connection with “qualified plan start-up costs”. For this purpose, qualified plan start-up costs are any ordinary or necessary expenses incurred with regard to the establishment of such plan, its administration or certain costs incurred related to employee investment education expenses.

Although beyond the scope of this article, it is noteworthy that the SECURE Act also established a tax credit for plans that implement an “eligible automatic enrollment arrangement” (“EACA”) of $500 for each of the first 3 years that the plan has such an auto enrollment feature. This “auto enroll” tax credit is separate and distinct from the start-up tax credit that is the subject of this article and both the start-up and auto enroll credits can be claimed concurrently. Also noteworthy is that the EACA need not be in place at the time the plan is established in order to qualify for the credit. As with the previously discussed small plan establishment tax credit, this credit is effective for tax years beginning after December 31,2019

Obviously, everyone’s tax situation is different so, as much as we hope this article helped you to better understand this topic, it is not to be construed as financial, tax or legal advice. Therefore, if you believe that it may apply to your (or your client’s) company, be sure to further discuss it with a qualified accountant or tax professional. For more information about this topic, please contact our marketing department at 484-483-1044 or your administrator at Legacy.

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