Discover Generous New Tax Credits for Start-Up 401(K) Plans

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RETIREMENT PLANNING

Establishing a retirement plan is a great way for employers to save for retirement and attract and retain valued employees. Newly expanded tax credits provide welcome relief from the costs associated with plan administration and company contributions. In fact, the tax credits may offset most or all plan costs over the first three years!

Who Qualifies for the Tax Credit?

- **New Plan:** Employer establishing a plan for the first time.
- **Small Business:** Employer with up to 100 employees earning at least $5,000. At least one employee must be non-highly compensated (NHCE)*.
- **Plan Type:** Defined contribution plans including: 401(k), SEP, and SIMPLE plans. Defined benefit/cash balance plans may claim the start-up tax credit but not the employer contribution credit.

What Credits Are Available?

Start-up Cost Tax Credit.

Snapshot: $250 X number of NHCE employees to a maximum of $5,000 per year covering administration fees for the first three years.

Initially effective in 2019, enhanced in 2023.

The startup tax credit enables businesses with up to 50 employees to claim a credit of 100% of eligible start-up costs based on the number of NHCEs eligible to participate in the plan. Specifically, the cap is the lesser of $250 multiplied by the number of NHCEs eligible for the plan or $5,000. The credit is reduced to 50% for businesses with 51-100 employees. Note that plans with only one eligible NHCE will receive the minimum credit of $500.

Eligible costs refer to ordinary and necessary expenses associated with establishing and administering the plan, as well as participant education. The credit can be claimed for the first three years of the plan, starting from the year prior to implementation. Only employer- paid expenses qualify for the credit.

Employer Contribution Tax Credit

Snapshot: Up to $1,000 of employer contributions per employee earning less than $100,000 for first two years, phased out over the following three years.

Effective in 2023.

Employers with 50 or fewer employees can receive tax credits of up to $1,000 per employee for company contributions, such as matching and profit-sharing contributions, to employees earning less than $100,000 in FICA wages (indexed). The full credit is available for two years and then gradually phases down over a five-year period, starting from the plan adoption date, and following a specified schedule.

For larger businesses with 51 to 100 employees, the credit percentage for the applicable year decreases by 2% for each employee exceeding 50.

Auto-Enrollment Tax Credit

Snapshot: $500 per Year for the First Three Years.

Effective in 2022.

The auto-enrollment credit is available to eligible employers who include an Eligible Automatic Contribution Arrangement (EACA) in a new retirement plan or add it to an existing plan. Businesses can claim $500 annually for a three-year taxable period, starting from the initial taxable year when the auto-enrollment feature is implemented. It's important to note that auto-enrollment will be required for start-up plans with over 10 employees beginning in 2025.

Example of Combined Tax Credits in Action!

Eagle Consulting has 25 employees and is establishing a 401(k) plan with automatic enrollment. There are 20 NHCE employees earning less than $100,000. Each employee receives at least $1,000 of employer contributions in the plan.

- **Startup Credit:** $250 X 20 NHCEs = $5,000 covering administration and education fees.
- **Employer Contribution Credit:** $1,000 employer contribution X 20 employees earning less than $100,000 = $20,000.
- **Automatic Enrollment Credit:** $500

Total first year tax credits: $25,500.

Maximum Credit Chart

# of Employees*	Startup Credit	Employer Contribution Credit	Auto Enrollment Credit	Year 1 Total Tax Credits
5	$1,250	$5,000	$500	$6,750
20	$5,000	$20,000	$500	$25,500
50	$5,000	$50,000	$500	$55,500
75	$5,000	$37,000	$500	$43,000
100	$5,000	$0	$500	$5,500

*NHCEs earning less than $100,000

Frequently Asked Questions

How do I claim the tax credits?

IRS Form 8881 can be used to claim the tax credits. The filing deadline is no later than three years from the eligible plan's start date.

How does a tax credit differ from a tax deduction?

Tax credits directly reduce your tax liability dollar for dollar, while tax deductions reduce the amount of income subject to taxes, making the credit much more valuable. Using the total tax credit example described above, the year one tax bill would be reduced by $25,500.

You may also deduct expenses not covered by the credit, but you cannot claim a tax credit and a tax deduction on the same amount.

Are 403(b) plans eligible?

No. The credits do not apply to tax-exempt entities.

If a company converts from a SIMPLE IRA to a 401(k) plan, does it qualify for startup credits?

No. Converting from one plan type to another does not qualify as a new plan according to the definition.

Contact your tax advisor for specific details on eligibility, qualifying expenses, and filing for the credits.

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* An NHCE is defined as any employee who is neither a >5% owner (either directly or through family attribution) nor has received compensation exceeding $155,000 in the prior year (applicable for 2024 plan years). Auto-Enrollment Tax Credit