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Credit Check:
Understanding the small plan tax credits

S. Derrin Watson

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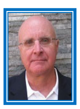

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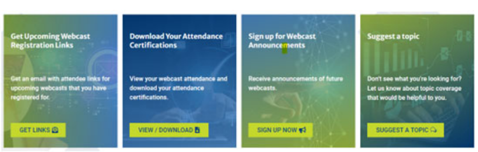

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Your Presenter Today

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Four credits for eligible employers

- Code §45E(a) Startup costs credit
- Code §45E(f) Employer contribution credit
- Code §45T EACA credit
- Code §45AA Military spouse

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What they have in common

- They are available for a limited number of years
- They are subject to dollar limits
- Only "Eligible employers" described in Code §408(p)(2)(C)(i) can claim them
  – That section defines who can set up a SIMPLE IRA
- We received guidance on all four credits in Notice 2024-2 or Notice 2020-68
- Credits aren't refundable
  – So tax-exempt and governmental can't use them

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408(p)(2)(C)(i) Eligible Employer

- (I) **In general.** The term "eligible employer" means, with respect to any year, an employer which had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year.
- (II) **2-year grace period.** An eligible employer who establishes and maintains a plan under this subsection for 1 or more years and who fails to be an eligible employer for any subsequent year shall be treated as an eligible employer for the 2 years following the last year the employer was an eligible employer.
  – If such failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence shall not apply.

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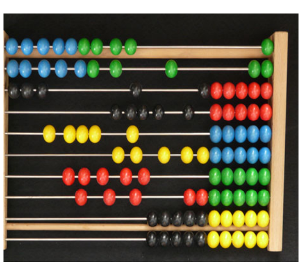
Guidance: Notice 98-4 §B



- Count employees of all related employers
  – Controlled group, ASG, etc.
- Count all employees, including union and nonresident alien, whether or not they meet eligibility requirements
  – Count them if they were employed at any time during the year
  – Include leased employees under Code §414(n)
- Count self-employed individuals (partners, sole proprietors)
  – Compensation is earned income

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Example of grace period

- Employer established plan in 2023
- 95 employees who earned at least $5,000 in 2022:
  – Eligible employer for 2023
- Increases to 105 employees in 2023
  – Is eligible employer for 2024 because of grace period
- Employer is acquired by large company in 2024
  – Total employees > 500
  – Grace period does not apply to 2025; not eligible employer

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Eligible automatic contribution arrangement (EACA) Credit Code §45T

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Overview

- Effective for tax years after 2019
- Credit is $500/year in “credit period”
- Credit period is first year EACA in existence and following two years
  – Eligible automatic contribution arrangement: Code §414(w)
  – Could be 401(k), SARSEP, or SIMPLE IRA
- EACA must be in existence in year 2 or 3 to claim the credit that year
- No requirement to have NHCEs in plan
  – Could apply to owner-only plan
- Claim all four credits on Form 8881

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Notice 2020-68 Guidance

- Only one 3-year credit period per employer
  - Adopting a second plan doesn't get you a new credit
- Credit period could have started before 2020: too bad
  - Employer adopted EACA in 2018
  - Credit period is 2018, 2019, and 2020
  - But you couldn't claim the credit before 2020
- You can claim a credit for years 2 and 3 only if EACA is in same plan as year 1
  - Spin-off treated as continuation of prior plan

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MEPs and credit

- Credit applies separately to each participating employer in MEP
- Example:
  - MEP has EACA feature
  - ABC joins MEP in 2023
  - ABC didn't previous have EACA
  - ABC's credit period is 2023, 2024, 2025
  - If ABC spins off its portion of plan to single employer plan in 2024, can still claim the credit for 2024 and 2025

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Form 8881

Part II	**Small Employer Auto-Enrollment Credit**		
9	Enter $500 if an auto-enrollment option is provided for retirement savings	9	
10	Small employer auto-enrollment credit from partnerships and S corporations	10	
11	Add lines 9 and 10. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1dd	11	

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Military Spouse Credit
Code §45AA

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Overview

- Applies to tax years beginning after 12/20/2022
- Limited to eligible small employer
  - Don't get to use 2-year grace period
- Limited to eligible defined contribution plan:
  - Military spouses must:
    - Be eligible to participate not later than 2 months after hire
    - Receive same employer contributions as other participants with 2 YOS
    - Be fully vested in employer contributions
- Military spouse does not include HCE

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Credit computation

- Credit computed separately for each military spouse
- Credit applies tax year spouse enters plan and the following two years
  - Assuming spouse is still a participant in subsequent years
- Amount:
  - $200 plus
  - Lesser of employer contribution or $300
- Aggregate all related employers

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Guidance in Notice 2024-2, §C

- Must qualify as eligible employer for year credit taken, without regard to two-year grace period
- Example XYZ began sponsoring eligible DC plan in 2023
- Military spouse Chris hired in 2025
- Credit years are 2025, 2026, 2027
- However, XYZ is eligible only for 2026

Year	Employees
2022	95
2023	97
2024	103
2025	100
2026	101

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Credit years

- 3-year period begins on later of:
  - Date spouse begins participation, or
  - Date plan amended to become eligible DC plan (with spouse participating)
- Example 1:
  - Kim enters conventional 401(k) plan in 2020
  - Calendar year employer amends plan into eligible DC plan in 2024
  - Can claim credit for Kim in 2024, 2025, and 2026

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Years before 2023

- Years before 2023 can count against credit period (if spouse participated in eligible DC plan), even though credit not available
- Example:
  - Surplus Store (calendar year taxpayer) adopts 401(k) plan in 2020
  - Plan provisions:
    - Immediate entry and vesting
    - 3% SH contribution
  - Taylor enters the plan in 2021
  - Can claim credit for Taylor for 2023, but that's it

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Form 8881

Part III **Military Spouse Participation Credit**

Caution: You can't claim the credit if you had more than 100 employees in the preceding tax year.

12	Enter the number of military spouse employees participating in an eligible plan. See instructions. ______ X $200	12	
13	Amount of contributions paid by employer for each eligible military spouse employee. Do not enter more than $300 per employee. See instructions	13	
14	Credit for small employer military spouse retirement plan from partnerships and S corporations	14	
15	Add lines 12, 13, and 14. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1ee	15	

Startup Costs Credit
Code §45E(a)

Overview

- Originally adopted as part of EGTRRA; amended in SECURE Act and SECURE 2.0
- Available for eligible employer (< 101 employees; 2-year grace)
- Not available if employer, related employer, or predecessor established or maintained plan for substantially the same employees as plan qualifying for credit
- Credit is generally 50% of qualified startup costs paid or incurred during tax year, subject to a limit, of new qualified plan, SEP, or SIMPLE IRA
- Related employers treated as single employer

Credit years

- First credit year
  - Generally tax year plan effective
  - Employer can elect to make it the year before the plan effective
- Credit is available for first credit year and the following two years

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Amount of credit

- Credit is generally 50% of qualified startup costs paid or incurred during tax year, subject to a limit
- Qualified startup costs: ordinary and necessary expenses of employer (i.e., not paid by plan) paid or incurred in connection with
  - Establishment or administration of plan
  - Retirement-related employee education with respect to plan
- If plan doesn't have at least one NHCE participant, qualified startup costs = $0 for purposes of credit

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Limit on credit

- Credit amount for a tax year can't exceed greater of
  - $500, or
  - $250/NHCE participant (not to exceed $5,000)

NHCEs	Dollar limit
0	0
1	$500
2	$500
4	$1000
10	$2500
15	$3750
20 or more	$5000

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Impact on deductions

- Employer can elect not to have credit apply
- If employer claims credit, cannot claim deduction for credit amount
- Example:
  - In 2024, Employer spends $2000 to set up cash balance plan
  - 2 NHCE participants
  - Credit limit is $500
  - Employer can claim $500 credit and can deduct $1500

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SECURE 2.0 change

- Credit increased to 100% of qualified startup costs if employer has no more than 50 eligible employees
  - Follow same rules as 100-employee limit
  - Same dollar limit applies
  - Effective for tax years beginning after 2022
- Example:
  - Dollar limit is $5000 (more than 20 NHCE participants)
  - 2024 Qualified startup costs = $7,000
  - If employer had 51 employees in 2023, credit is $3,500
    - Lesser of 50% of costs or $5,000
  - If employer had 50 employees in 2023, credit is $5,000
    - Lesser of 100% of costs or $5,000

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Notice 2024-2, §B

- Must satisfy eligibility in first credit year to qualify for any of the three years; must also satisfy eligibility for year credit claimed.
  - Can qualify for 100% credit only if no more than 50 employees for first credit year (even if that year was before 2023)
- Examples for plan effective in 2022

Year	EEs	Credit %
2021	20	
2022	23	50%
2023	25	100%
2024		100%

Year	EEs	Credit %
2021	51	
2022	49	50%
2023	48	50%
2024		50%

Year	EES	Credit %
2021	99	
2022	101	50%
2023	102	50%
2024		50%

Year	EES	Credit %
2021	102	
2022	89	0%
2023	90	0%
2024		0%

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Form 8881

Part I	**Credit for Small Employer Pension Plan Startup Costs (Including Employer Contributions)**	
A	Enter the number of qualifying employees. See instructions	
1	Qualified startup costs incurred during the tax year	1
2	Employers with 1-50 employees enter the amount from line 1. Employers with 51-100 employees enter 50% (0.50) of line 1	2
3	Enter the number of employees eligible to participate in the pension plan. See instructions. ______ X $250	3
4	Enter the greater of $500 or the amount from line 3 (Do not enter more than $5,000)	4
5	Enter the smaller of line 2 or line 4	5

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Employer contribution credit
Code §45E(f)

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Overview

- Applies to tax years beginning after 2022
- Separate from credit for qualified startup costs
- Available for eligible employer (< 101 employees; 2-year grace)
- Not available if employer, related employer, or predecessor established or maintained plan for substantially the same employees as plan qualifying for credit
- Limited to defined contribution plans
- Related employers treated as single employer
- Can qualify even if no NHCE participants

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Year it can be claimed

- Year 1 is always year plan effective
  – Even if employer elects prior year for first credit year for startup costs credit
- Employer must be eligible employer for Year 1 to claim credit in any year
- Employer must be eligible employer for year credit is claimed

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Credit is computed participant by participant

- Disregard participants with FICA wages > $100,000 (indexed)
  – Sole proprietors and partners don't have FICA wages
  – Look at wages for the tax year for which credit is claimed
- Example
  – Dr. Doris is sole proprietor; 2023 earned income is $400,000; counts
  – 2 W-2 employees
    - Physician's assistant, Peter; wages $110,000; disregarded
    - Doris' husband, Harold; wages $70,000; counts

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Dollar limit; Phase-out

- Credit for a participant is lesser of
  – Employer contributions (match and nonelective) for the participant
  – $1,000
- Maximum credit based on employees in prior tax year
  – Full credit if no more than 50 employees in prior year
  – No credit if more than 100 employees
  – Credit phases out in between (2% for every EE > 50)

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Example

- Employer has 60 employees who earned at least $5,000 in 2024
  - Some weren't eligible to participate, but they count
- Carlos' 2025 allocation = $2,400
- Kim's 2025 allocation = $500
- Credit available for Carlos and Kim if there were only 50 employees in 2024 would be $1,500
- But there were 60 employees; credit reduced 20%
- Credit is $1,200

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Applicable percentage

- Credit is available for only first 5 years plan effective and phases out
- Years before 2023 count for phase-out
  - Example; plan established in 2021
    - 75% credit available in 2023

Year	Applicable %
1st	100%
2nd	100%
3rd	75%
4th	50%
5th	25%
6th and later	0%

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Summary
Credit for each employee is as follows

1. If employee had FICA wages > $100,000, credit is $0
2. Determine employer contribution (match + nonelective)
3. Lesser of line 2 or $1,000
4. If greater than 50 employees in prior year, reduce line 3 by 2% for each employee > 50
5. Apply applicable percentage to line 4

Year	Applicable %
1st	100%
2nd	100%
3rd	75%
4th	50%
5th	25%
6th and later	0%

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Let's do the math

- Safe harbor nonelective plan
- 60 countable employees each receive more than $1,000 employer contribution
  - Potential $60,000 credit
- 70 employees total
  - Reduces max credit to 60%=$36,000

Year	Applic. %	60%	Credit
1st	100%	60%	$36,000
2nd	100%	60%	$36,000
3rd	75%	45%	$27,000
4th	50%	30%	$18,000
5th	25%	15%	$9,000

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Relationship to deductions

- Can't claim deduction for credit amount
- Credit claimed for tax year in which deduction would be claimed
- Example:
  - Calendar year employer contributes nonelective contribution for 2024 on February 5, 2025
    - Allocated as of December 31, 2024
  - Take the credit against 2024 taxes
  - Suppose total employer contribution for 2024 =$60,000 and credit is $20,000
    - Deductible amount is $40,000

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6a	Enter the number of employees from the preceding tax year. See instructions	6a	
b	Enter employer contributions made to the plan, but don't include (i) elective deferrals, (ii) contributions made to employees whose wages paid to the employee were in excess of $100,000 and (iii) any amount of contributions to an employee to whom you made contributions of more than $1,000	6b	
c	For employees for whom you made matching and nonelective contributions of more than $1,000, (and who are not disqualified because they meet 6b(ii) above), see the instructions for information on how to determine the amount to enter on line 6c. If you did not make this type of contributions, enter -0-	6c	
d	Add lines 6b and 6c	6d	
	If the number of employees entered on line 6a is 50 or less, enter the amount from line 6d on line 6f. If the number of employees entered on line 6a is 51-100, continue to line 6e(1).		
e	(1) Subtract 50 (50.0) from the number of employees entered on line 6a	6e(1)	
	(2) Multiply line 6e(1) by 2% (0.02)	6e(2)	
	(3) Multiply line 6e(2) by line 6d	6e(3)	
	(4) Subtract line 6e(3) from line 6d	6e(4)	
f	If you did NOT complete line 6e, enter the amount from line 6d. If you completed line 6e, enter the amount from line 6e(4)	6f	
g	Applicable percentages. See instructions	6g	
	• If this is treated as the first or second year of the plan, enter the amount from line 6f. • If this is treated as the third year of the plan, multiply line 6f by 75% (0.75). • If this is treated as the fourth year of the plan, multiply line 6f by 50% (0.50). • If this is treated as the fifth year of the plan, multiply the amount on line 6f by 25% (0.25).		
7	Credit for small employer pension plan startup costs from partnerships and S corporations	7	
8	Add lines 5, 6g, and 7. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	8	

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Comparing the credits

	EACA	Military Spouse	Startup Costs	Employer Contrib
Code §	45T	45AA	45E(a)	45E(f)
Years available	3	3 per employee	3	5
Limited to new plans	No	No	Yes	Yes
Must have NHCE	No	Yes	Yes	No
Limit	$500	$500/employee	Based on NHCEs	$1000/employee
2-year grace applies	Yes	No	Yes	Yes
Special rule for under 50	No	No	Yes	Yes
Impacts deduction	No	No	Yes	Yes

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Thank you!

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- Derrin's books are available at ERISApedia.com
  - Plan Distribution eSource
  - Who's the Employer (8th ed)
  - 403(b) Plan eSource
  - 457 Plan eSource
  - Plan Correction eSource (with Ilene Ferenczy and Alison Cohen)

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A Few Reminders

- ASPPA/NIPA and ERPA certificates will be emailed within a day or two.
- Go to ERISApedia.com WEBCAST tab to retrieve previous certificates.
- After the webcast you will be presented with a short google forms survey. Please let us know how we are doing.
- Joanne Pecina will demonstrate how to find more information on today's topic from the ERISApedia.com resources

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