Small-business retirement
plan sponsors

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A closer look at the **SECURE Act startup tax credit**

Whether you're considering or in the process of setting up a small-business retirement plan, or you've established one in the past few years, learn how you can potentially benefit from the increased federal tax startup credit.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act intends to improve retirement savings. One of the Act's most attractive provisions has made it less expensive for many small businesses to start new retirement plans, including 401(k)s, SEP IRAs and SIMPLE IRAs.

What is the startup tax credit?

The credit reduces the amount of federal taxes that an employer may owe on the small business's first-ever retirement plan for the plan's first three tax years. The credit covers 50% of the employer's ordinary and necessary out-of-pocket plan costs, up to a certain limit. For tax years beginning after December 31, 2019, the maximum annual credit is $500 or, if greater, $250 multiplied by the number of plan-eligible non-highly compensated employees, up to $5,000. Previously, the maximum credit was $500 a year.

Startup tax credit at a glance

- For the plan's first three tax years
- Credit = 50% of employer plan costs
- Maximum credit is $500, or up to $5,000 based on formula
- Formula: $250 × the number of eligible NHCEs, not to exceed $5,000

What are the eligibility requirements for the credit?

To qualify for the credit, businesses must meet all of the following requirements:

- No more than 100 employees who received compensation of $5,000 or more in the preceding year.
- At least one plan participant who was a non-highly compensated employee.
- Employer didn't offer a plan covering substantially the same employees during the previous three tax years.

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Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

What types of plan costs does the credit apply to?

The credit covers 50% of ordinary and necessary plan costs paid by the employer to set up and administer the plan – such as advisor and TPA compensation, recordkeeping fees and employee education expenses – up to the limit, as previously shown. The credit **does not apply** to plan costs paid through plan assets or investment expenses. This can be a significant distinction; see the next question.

How does the credit apply to different plan types and share classes?

The credit only applies to plan costs that the employer pays out of pocket – not costs paid by participants through investment expenses or costs paid from plan assets. This can limit the amount of the credit for certain plan types and share classes. For example, SEP IRAs and SIMPLE IRAs have low employer costs, so the credit amount for these plan types are generally limited. Share classes with higher expense ratios, part of which are generally used to help pay plan costs, may also have limited benefit. 401(k) plans with institutional (or fee-based) share classes generally pay more plan costs out of pocket, so therefore may be able to receive more benefit from the credit.

If a plan started before 2020, can it qualify for the increased credit?

A plan can apply the higher maximum tax credit set by the SECURE Act for any of its first three tax years that begin after December 31, 2019. For example, if a plan's second tax year began on January 1, 2020, the plan would qualify for the higher credit for its second and third tax years.

Example of how the credit is calculated

Suppose a new 401(k) plan sponsor has 10 non-highly compensated employees and pays first-year plan setup fees of $500, recordkeeping and administration fees of $2,000, a TPA fee of $750, financial professional compensation of $1,000, and a third-party fiduciary services fee of $250.

The maximum credit would be $2,500 ($250 × 10). Employer plan costs total $4,500, so 50% would be $2,250. **In this case, the tax credit would be $2,250.**

Other details, rules and exceptions may apply. Consult your financial professional or legal advisor for more information.

*As of December 31, 2019.

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