

425 \$500 maximum credit for pension plan startup costs of small employers during each of the first three years of the plan--costs paid or incurred in tax years beginning after Dec. 31, 2001
 Analysis of the Economic Growth and Tax Relief Reconciliation Act of 2001

¶ 425. \$500 maximum credit for pension plan startup costs of small employers during each of the first three years of the plan—costs paid or incurred in tax years beginning after Dec. 31, 2001

Code Sec. 45E, as added by 2001 Act §619(a)

Code Sec. 38(b)(14), as amended by 2001 Act §619(b)

Code Sec. 39(d)(10), as amended by 2001 Act §619(c)(1)

Code Sec. 196(c)(10), as amended by 2001 Act §619(c)(2)

Generally effective: Costs paid or incurred in tax years beginning after Dec. 31, 2001

Committee Reports, see ¶5047

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business. See FTC 2d/Fin ¶H-10034; PCA ¶30,135; PE ¶404-4; TaxDesk ¶280,530; USTR ¶4044; .

Under pre-2001 Act law, there was no general business credit under Code Sec. 38 available for small employer pension plan startup costs. FTC 2d/Fin ¶L-15200; USTR ¶384; TaxDesk ¶380,500;

New Law. For purposes of the general business credit, in the case of an *eligible employer* (defined below), the small employer pension plan startup cost credit for any tax year will be an amount equal to 50% of the *qualified startup costs* (defined below) paid or incurred by the taxpayer during the tax year. (Code Sec. 45E (a) as added by 2001 Act §619(a)) Thus, the 2001 Act provides a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a Code Sec. 401(k) plan), SIMPLE plan, or simplified employee pension ("SEP"). (Com Rept, see ¶5047)



RIA illustration 1: An eligible employer (E) incurs \$750 of qualified startup costs. E's small employer pension plan startup cost credit will be for 50% of those costs or \$375. For the effect of the credit on E's deduction of the qualified startup costs, see the discussion under the heading **Disallowance of deduction if the credit is claimed** below.

For dollar limitations on the amount of the credit, see below.

Eligible employer defined.

An "eligible employer" will have the same meaning as that term has in Code Sec. 408(p)(2)(C)(i) which defines the types of employers that are eligible to adopt SIMPLE IRA plans (i.e., an employer that employs 100 or fewer employees who received *at least* \$5,000 of "compensation" from the employer for the preceding year), see FTC 2d/Fin ¶H-12351; PCA ¶35,552; PE ¶408-4.06; TaxDesk ¶28,331; USTR ¶4084.06;). (Code Sec. 45E(c)(1))



RIA observation: The Committee Report indicates that the credit will be available to an employer that did not employ, in the preceding year, more than 100 employees with compensation *in excess of* \$5,000. This description of the type of employer that can claim the credit (i.e., "eligible employer") misstates the definition of an "eligible employer" in Code Sec. 408(p)(2)(C)(i) , which says that compensation must be "at least \$5,000".

But, an eligible employer won't include an employer if, during the three-tax year period immediately preceding the first tax year for which the small employer pension plan startup cost credit is otherwise allowable for a qualified employer plan of the employer, the employer or any member of any controlled group including the

employer (or any predecessor of either) established or maintained a qualified employer plan with respect to which contributions were made, or benefits were accrued, for substantially the same employees that are in the qualified employer plan. (Code Sec. 45E(c)(2))



RIA observation: For a calendar year taxpayer, the first tax year for which the small employer pension plan startup cost credit will be otherwise available is 2002 and the employer can't have maintained or established a plan for the preceding three-year period (i.e., '99, 2000, and 2001). Thus, an employer will have to establish the plan after 2001 in order to be considered to be an eligible employer for purposes of claiming the credit.



RIA recommendation: If an employer (who otherwise meets the definition of an eligible employer) was considering establishing a plan in 2001, the employer may want to consider delaying the establishment of the plan until 2002 so that the employer will be eligible for the credit.

Qualified startup costs defined.

For purposes of the credit, qualified startup costs means any ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with: (Code Sec. 45E(d)(1)(A))

- ... the establishment or administration of an eligible employer plan (defined below), or (Code Sec. 45E(d)(1)(A)(i))
- ... the retirement-related education of employees with respect to the eligible employer plan. (Code Sec. 45E(d)(1)(A)(ii))

Requirement of at least one-nonhighly compensated participant.

Qualified startup costs won't include any expense in connection with a plan that doesn't have at least one employee eligible to participate who is *not* a highly compensated employee. (Code Sec. 45E(d)(1)(B)) Thus, in order for an employer to be eligible for the credit, the plan will have to cover at least one nonhighly compensated employee. Also, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement will have to be made available to all employees of the employer who have worked with the employer for at least three months. (Com Rept, see ¶15047)



RIA observation: Since Code Sec. 45E(d)(1)(B) doesn't define the term "highly compensated employee", presumably, the definition will be similar to the definition provided in Code Sec. 414(q) for purposes of the discrimination rules that apply to many qualified retirement plans (see FTC 2d/Fin ¶H-6702; PCA ¶24,803; PE ¶414-4.21; TaxDesk ¶286,012; USTR ¶4144.21;). Also, Code Sec. 45F (the credit for employer-provided child care that was added by Sec. 205 of the 2001 Act, see ¶602) incorporates the definition of "highly compensated employee" from Code Sec. 414(q) by reference in Code Sec. 45F(c)(2)(B)(iii) .

Eligible employer plan defined.

For purposes of the credit, an eligible employer plan is a qualified employer plan within the meaning of Code Sec. 4972(d) (the excise tax on nondeductible contributions to qualified plans, see FTC 2d/Fin ¶H-10301; PCA ¶30,402; PE ¶4972-4; TaxDesk ¶281,802; USTR ¶49,724;). (Code Sec. 45E(d)(2))



RIA observation: Thus, an eligible employer plan will include:

- any qualified pension, profit-sharing, or stock bonus plan which includes an exempt trust,
- a qualified annuity plan,
- a simplified employee pension, and
- any simple retirement account (i.e., any SIMPLE IRA).

All eligible employer plans will be treated as one eligible employer plan. (Code Sec. 45E(e)(1))

\$500 limitation.

The amount of the credit for any tax year *can't exceed*: (Code Sec. 45E(b))

- ... \$500 for the first credit year and each of the two tax years immediately following the first credit year (defined below), and (Code Sec. 45E(b)(1))
- ... zero for any other tax year. (Code Sec. 45E(b)(2))

Thus, the credit will apply to 50% of the first \$1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan. (Com Rept, see ¶5047)

 **RIA illustration 2:** An eligible employer (E) incurs \$1,750 of qualified startup costs for the first credit year. Before applying the dollar limitation provided in Code Sec. 45E(b)(1) , E's credit will be 50% of E's qualified startup costs or \$875. However, the dollar limitation will reduce E's credit to \$500.

First credit year defined.

For purposes of the dollar limitation, the "first credit year" is: (Code Sec. 45E(d)(3))

- (1) the tax year which includes the date that the eligible employer plan (defined below) to which the qualified startup costs relate becomes effective, or (Code Sec. 45E(d)(3)(A))
- (2) at the election of the eligible employer (defined above), the tax year preceding the tax year referred to in (1) above. (Code Sec. 45E(d)(3)(B))

 **RIA recommendation:** If an eligible employer incurs more than \$1,000 in qualified startup costs in the year *before* it establishes the eligible employer plan, it may want to make the election under Code Sec. 45E(d)(3)(B) (see (2) above) to have the tax year preceding the first credit year be considered to be the first credit year.

 **RIA caution:** An eligible employer can't elect under Code Sec. 45E(d)(3)(B) (see (2) above) to treat 2001 as the first credit year for an eligible employer plan that will become effective in 2002 because Code Sec. 45E only applies to costs paid or incurred *after Dec. 31, 2001* (see below).

 **RIA observation:** The rules relating to the credit don't specify how an election under Code Sec. 45E(d)(3)(B) (see (2) above) will be made. Presumably, IRS will provide guidance on this issue.

Disallowance of deduction if the credit claimed.

No deduction will be allowed for that portion of the qualified startup costs paid or incurred for the tax year which is equal to the small employer pension plan startup cost credit. (Code Sec. 45E(e)(2)) Thus, the 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under tax law other than Code Sec. 45E (see FTC 2d/Fin ¶H-10034; PCA ¶30,135; PE ¶404-4; TaxDesk ¶280,530; USTR ¶4044;). (Com Rept, see ¶5047)

 **RIA illustration 3:** An eligible employer (E) incurs \$750 of qualified startup costs and claims the small employer pension plan startup cost credit for \$375 of those costs. E will have to reduce its deduction for the startup costs by \$375 (the amount of the credit). Thus, E's deduction will be \$375.

 **RIA observation:** In the situation where an eligible employer's qualified startup costs exceed \$1,000, the above statement from the Committee Report that indicates that "the other

50% of the qualifying expenses (and other expenses) are deductible” may not reflect the language of Code Sec. 45E(e)(2) (that indicates that there is no deduction for the portion of the qualified startup costs paid or incurred for the tax year which is equal to the credit). Where the startup costs exceed \$1,000 and the amount of the credit is limited to \$500 by the dollar limitations provided in Code Sec. 45E(b) , presumably, an eligible employer will merely reduce the amount of his deduction by the amount of the credit that he is allowed (after the application of the dollar limitations) and elects to claim.

 **RIA illustration 4:** The facts are the same as in illustration (2) above. E's credit will be \$500 and he will have to reduce his deduction by that amount. E's deduction will be \$1,250 (\$1,750 – \$500).

 **RIA observation:** Presumably, this deduction disallowance rule doesn't mean that an employer can't take a deduction under Code Sec. 196(c)(10) (see below) for an otherwise allowable small employer pension plan contribution credit (when combined with the employer's other credits) which can't be used because of the limitation on the general business credit under Code Sec. 38(c) (see FTC 2d/Fin ¶L-15202; TaxDesk ¶380,502; USTR ¶384.02;) due to the employer's tax liability. The deduction under Code Sec. 196(c)(10) should be allowable after the credit carryover period expires.

Election out of the credit.

The credit will not apply to a taxpayer for any tax year if the taxpayer elects to have the credit not apply for that tax year. (Code Sec. 45E(e)(3))

 **RIA observation:** In most cases, it will be advantageous for employers to claim the credit (rather than electing out of the credit). But, a taxpayer subject to the alternative minimum tax (AMT) might reduce his overall tax liability by electing out of the credit because the credit will be part of the general business credit and can't be used against the AMT (see FTC 2d/Fin ¶L-15202; TaxDesk ¶380,502; USTR ¶384.02;).

 **RIA observation:** The rules relating to the credit don't specify how an eligible employer will make the election. Presumably, IRS will provide guidance on this issue. This guidance might provide that a taxpayer elects out of the credit by not claiming it on the return (the way that a taxpayer elects out of the work opportunity tax credit, see FTC 2d/Fin ¶L-17781; TaxDesk ¶380,704; USTR ¶514; .)

Aggregation rules.

All persons treated as a single employer under Code Sec. 52(a) or Code Sec. 52(b) (which treat employees of certain employers as employed by the same employer for purposes of the work opportunity credit, see FTC 2d/Fin ¶L-17787; TaxDesk ¶380,718; USTR ¶514;), or Code Sec. 414(n) or Code Sec. 414(o) (rules relating to employee leasing, see FTC 2d/Fin ¶H-5600; PCA ¶23,401; PE ¶414-4.19; USTR ¶4144.19;), will be treated as one person. (Code Sec. 45E(e)(1))

 **RIA observation:** One effect of the aggregation rules is that two closely related taxpayers will be treated as one taxpayer for purposes of the \$500 limitation on the amount of the credit (see above).

Credit is part of the general business credit.

In the case of an eligible employer (as defined above), the small employer pension plan startup cost credit will be part of and subject to the general business credit rules, see FTC 2d/Fin ¶L-15209; TaxDesk ¶380,500; USTR ¶394; . (Code Sec. 38(b)(14) as amended by 2001 Act §619(b)) However, no portion of the unused business credit for any tax year which is attributable to the small employer pension plan startup cost credit can be carried back to a tax year beginning before Jan. 1, 2002. (Code Sec. 39(d)(10) as amended by 2001

Act §619(c)(1))



RIA observation: Thus, if an employer (using the calendar year as its tax year) has an unused business credit for 2002 (the first year that the small employer pension plan startup cost credit will be in effect) which is attributable to the small employer pension plan startup cost credit, it can't carry the unused credit back to 2001 under the carryback rules that generally apply to the general business credit. It will have to carry the unused credit forward under the rules discussed in FTC 2d/Fin ¶L-15209; TaxDesk ¶380,506; USTR ¶394; .

The small employer pension plan startup cost credit will be included in the term "qualified business credits" for which a deduction is allowed under Code Sec. 196 for unused portions of credit. The deduction will be allowed in the first tax year after the last tax year for which a credit could have been allowed, that is, at the expiration of the credit carryover period, see FTC 2d/Fin ¶L-15212; TaxDesk ¶380,510; USTR ¶1964; . (Code Sec. 196 (c)(10) as amended by 2001 Act §619(c)(2))

Effective: Costs paid or incurred in tax years beginning after Dec. 31, 2001, with respect to qualified employer plans established after Dec. 31, 2001. (2001 Act §619(d))

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