Client Alert

DANZIGER & MARKHOFF LLP
Attorneys at Law

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Which Way to Turn?

As State Payroll Deduction IRA Mandates Take Effect, Enhanced Federal Tax Credits Signal Employer-Sponsored Retirement Plan Alternative

1. Overview

Many states have enacted or are in the process of enacting or implementing legislation requiring employers to facilitate their employees' enrollment in state-sponsored payroll deduction individual retirement account (IRA) programs. States with active programs include New Jersey, Connecticut and California, among others. While New York has enacted its own "Secure Choice Savings Program" law, the program has yet to be implemented.[1]

Significantly, the state programs provide an alternative: businesses that offer their employees an employer-sponsored retirement plan are exempt from these state mandates.

In evaluating which way to turn, small employers should take into account enhanced federal income tax credits that can significantly defray the cost of adopting and initially maintaining a new employer-sponsored retirement plan.

In this article, we:

- summarize some common characteristics of the state-mandates,
- describe and illustrate the federal small employer "new plan" tax credits as enhanced by the SECURE Act and SECURE 2.0 Act, and
- suggest some factors that employers may consider in evaluating which path to take.

2. Characteristics of State-Mandated Payroll IRAs

Although there are differences by state, most state programs share the following general characteristics:

[1] See, for example: https://www.vestwell.com/blog/the-new-york-state-secure-choice-savings-program-everything-you-need-to-know

- covered employers are required to register with the state and facilitate their employees' enrollment in the program;
- after-tax Roth IRAs are typically used (although NJ permits a traditional IRA alternative);
  - ◊ ***Due to the Roth IRA income limits, many owners and higher-paid employees will find themselves ineligible to participate in the state programs***
- employees are automatically enrolled in the program at a specified contribution rate of compensation (generally 3%), unless an employee affirmatively elects otherwise;
- employee contributions are transferred to a payroll-deduction IRA that is established under the state program in the employee's name; and
- the state selects investment firms and investments used by the program.

The state programs exempt very small (e.g., less than from 5 to 25 employees, depending on the state), or new, employers.

Importantly, employers that maintain their own qualified retirement plan are exempt from the state mandates.

3. Enhanced Small Employer New Plan Tax Credits

A. Description of Tax Credits

The SECURE Act and SECURE 2.0 Act substantially enhanced the tax credits available for small employers that adopt a new tax-qualified retirement plan. These tax credits include:

- ***Startup Cost Credit***
- ***Contribution Credit***
- ***Auto-Enrollment Credit***

For this purpose, an employer is considered a small employer if it has 100 or fewer employees with compensation of $5,000 or more in the preceding year. Small employers must also satisfy the following two conditions to be eligible for the Startup Cost Credit and the Contribution Credit:

- have at least one non-highly compensated employee (NHCE)[2] who is eligible to participate in the new plan, and
- have not maintained another qualified employer plan[3] for substantially the same employees during the preceding three years.

The three tax credits are summarized in the table below.

[2] An employee who earned $155,000 or less from the employer in 2024 is considered an NHCE for 2025. However, owners are generally <u>not</u> NHCEs regardless of their compensation level.

[3] For this purpose, "qualified employer plan" means a tax-qualified retirement plan (such as a 401(k) plan), 403(b) plan, simplified employee pension ("SEP") or a SIMPLE retirement account.

	Startup Cost Credit	Contribution Credit	Auto-Enrollment Credit
Eligibility for credit	≤ 100 employees; reduced for 51-100 employees	≤ 100 employees; phase-out for 51-100 employees	≤ 100 employees in tax year before 1st credit year Credit available even if plan subject to mandatory auto enrollment under SECURE 2.0
Duration of credit	First 3 plan years	First 5 plan years	First 3 plan years in which plan has an eligible automatic contribution arrangement
Amount of credit	100% of qualified startup costs (50% if > 50 employees) Credit capped at $5,000, or, if less, $250 x number of eligible NHCEs; minimum: $500. Qualified startup costs: expenses incurred in establishing or administering a plan, and certain retirement education expenses.	Percentage* of employer contributions to plan for employees with wages up to $105,000 (subject to inflation adjustments), limited to $1,000 / employee / year *Percentages: Y1 100% Y2 100% Y3 75% Y4 50% Y5 25%	$500 / year

While an employer cannot claim a tax deduction for the portion of these costs taken as a tax credit, a tax credit is more valuable than a tax deduction. When claimed as a tax credit, 100% of the applicable cost is a dollar-for-dollar reduction in the employer's tax liability.

An employer that adopted a new plan within the last five years can claim the relevant tax credits for whatever years remain available.

Eligible small employers use Internal Revenue Service **Form 8881** (Parts I and II) to claim these tax credits.

B. Illustration of Tax Credits

Especially when used in combination, these credits can generate substantial tax savings over a period of years for an employer that adopts a new plan. These tax savings may offset some or all of the costs of establishing and maintaining a new plan as illustrated by the following simple example.

> Harold is the owner of Hoppy Harold's, a popular craft brewery and brew pub located in Connecticut. Hoppy Harold's has 20 staff employees, none of whom have annual compensation over $105,000. Harold heard about the CT payroll IRA mandate and the enhanced new plan tax credits. Harold wants to adopt a new 401(k) profit sharing plan beginning in 2025, using the tax credits, to opt out of the CT mandate. The plan will include a "safe harbor" employer contribution to facilitate the plan's compliance with federal income tax rules. This means that Hoppy Harold's will make an annual contribution to the plan equal to 3% of each eligible employee's compensation.

	Compensation	401(k)	Safe Harbor	Profit Sharing*
Harold (owner)	$ 350,000	$31,000	$10,500	$21,000
20 staff employees (total)	1,500,000		45,000	

	2025	2026	2027	2028	2029
Owner Contribution	$62,500**	$62,500	$62,500	$62,500	$62,500
Staff Cost	45,000	45,000	45,000	45,000	45,000
Contribution Tax Credit	(20,000)	(20,000)	(20,000)	(20,000)	(11,250)
Staff Cost After Contribution Tax Credit	25,000	25,000	25,000	25,000	33,750
Owner % (post-credit)	71%	71%	71%	71%	65%
Startup Cost Credit	$(5,000)	$(5,000)	$(5,000)		
Auto Enrollment Credit	(500)	(500)	(500)		

* The availability of additional profit sharing allocations for Harold is dependent on the employee demographics of Hoppy Harold's.

** This amount is the sum of the following amounts: 401(k), Safe Harbor and Profit Sharing.

	Tax-Qualified Retirement Plan	**State-Mandated IRA Program**
Is the small employer new plan tax credit available?	Yes	No
What are the annual contribution limits?	$70,000 (or $77,500 if age 50-59 or 64 or older; or $81,250 if age 60-63)	$7,000 (or $8,000 if age 50 or older)
Are tax-deductible employer contributions permitted?	Yes	No
Is there a choice between pre-tax and Roth after-tax contributions?	Yes	Generally, no (with limited exceptions by state)
Can higher earners participate?	Yes	Owners and employees with incomes above the Roth IRA limits* are not eligible for state programs that use Roth IRAs *Married filing jointly: $246,000 Single: $165,00
Who determines investment alternatives?	Employer	State government
What about fees?	Employer determines fee structure and how fees are paid	State program administrative costs are assessed against individual employee accounts
Are eligibility and vesting conditions permitted?	Yes, the plan may impose eligibility conditions and vesting conditions for employer contributions	No
Promotes employee recruitment and retention?	Yes – a 401(k) plan is viewed by many employees as an expected and fundamental employee benefit	Not so much

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If you have any questions about the small employer new plan tax credits, the state government payroll IRA mandates or employer-sponsored qualified retirement plans, please contact Andrew Roth at (914) 220-8033, ARoth@dmlawyers.com. Andy is a partner in our firm.

914.948.1556 • DanzigerMarkhoff.com

Westchester Office:
1133 Westchester Avenue, Suite N208, White Plains, New York 10604

Long Island Office:
105 Maxess Road, Suite 124, Melville, NY 11747