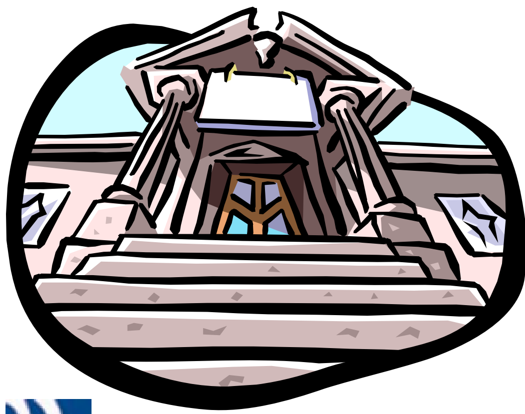

The Employee Benefits Group

THE ESOP ADVISOR

401(K) + ESOP = KSOP
A Winning Formula

Many corporations have established a 401(k) plan for their employees. Others have adopted an Employee Stock Ownership Plan ("ESOP") as their retirement program. A few employers maintain both types of plans. This article will discuss how these plans can be used together to provide increased advantages for employers and larger benefits for employees.

A 401(k) plan allows an eligible employee to contribute part of his/her salary to a retirement plan on a tax deductible basis. Many 401(k) plans also provide for a matching contribution by the employer equal to some percentage of what the employee has contributed. For example, a matching formula might be something like: 50% of the employee's 401(k) contribution, but not more than 3% of pay.

An ESOP is a retirement plan designed to invest primarily in stock of the employer. ESOPs have been granted many special tax advantages as an incentive for the employer to share company stock with employees. These advantages include a corporate tax deduction for repayment of loan principal, an optional waiver of capital gains tax by a selling shareholder, a corporate tax deduction for payment of dividends on stock owned by the ESOP, the ability to eliminate all or a part of income tax on business profits through an S Corporation ESOP, and the opportunity for employees to accumulate capital ownership on a tax deferred basis with no out-of-pocket expense on their part.

Under a typical ESOP, a loan will be used by the plan to purchase stock from a shareholder or directly from the employer itself. The loan is repaid from cash transferred to the ESOP by the employer. The cash may come from the employer in the form of tax deductible retirement plan contributions, tax deductible dividends paid on ESOP stock, or tax-free shareholder distributions from an S Corporation employer. Stock purchased by the ESOP with the loan will be allocated to eligible employees as the loan is repaid. Usually this allocation is based on the compensation earned by each employee, or on a basis which considers both compensation and years of service with the employer.

A combined 401(k) and ESOP ("KSOP") produces a unique retirement plan design with special benefits to both employers and employees. Here's how:

1. **Matching Contributions**. The ESOP stock purchased with a loan can be allocated as a matching contribution under a 401(k) plan. For example, if an employee contributes $1,000 to a 401(k) plan with a 50% matching formula, $500 worth of stock would be allocated to that employee as the annual matching contribution. This has the advantage of allowing all employer cash contributed to a retirement plan to be used to repay the ESOP loan (resulting in earlier loan repayment). However, it also offers an incentive for employees to make 401(k) deferrals. With this plan design all cash contributed by the employer will be used to repay the loan, with tax deductible dollars, but the cash will also double as a 401(k) matching contribution.

2. **Safe-Harbor Contribution**. A 401(k) plan may be designed as a "safe harbor" plan, so that annual percentage testing ("ADP test") is not required for 401(k) contributions. Without the ADP test, the "highly compensated employees" ("HCEs") can contribute the maximum 401(k) contribution each year

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($16,500 in 2009, plus an additional $5,500 if over age 50) without regard to the amount of 401(k) contributions made by other employees. To be a safe harbor 401(k) plan the employer must either contribute a fully vested 3% of pay for all eligible employees, or a fully vested 4% matching contribution for employees who make 401(k) contributions. The employer can contribute cash to the ESOP to repay the loan. The ESOP stock can then be allocated as the safe harbor contribution. This design allows the contributed cash to repay the ESOP loan and also allows the 401(k) plan to avoid the administrative burden and expense of performing the ADP test each year (and the return of 401(k) contributions to HCEs). HCEs can then maximize their 401(k) contributions.

3. **Multiple ESOP Allocation Methods.** The ESOP may provide that stock to be allocated to participants each year will be allocated using multiple methods. For example, the stock could first be allocated as a safe harbor contribution, allowing HCES to maximize their 401(k) deferrals. Next, additional stock can be allocated as a matching contribution for employees who make 401(k) contributions. Finally, any remaining shares can be allocated based on compensation or years of service.

Even if the employer's ESOP has no outstanding loan, the KSOP design can still be used. The employer could contribute newly issued shares each year to the ESOP equal to the matching contribution or the safe harbor contribution. This will improve corporate cash flow, since a tax deduction is available to the employer for the fair market value of contributed stock. Cash, which otherwise would have been used to make the employer contribution, can be retained by the corporation for other purposes.

If you would like to learn more about the KSOP concept, please contact Vern Saper at Warner Norcross & Judd at 616.752.2116 or at vsaper@wnj.com.

EDITOR'S NOTE: This mailing from the Warner Norcross & Judd LLP Employee Benefits Group is being e-mailed to current WN&J ESOP clients, clients who have expressed interest in ESOPs, and other ESOP professionals and interested parties. If there are others within or outside your organization who might benefit from this newsletter, please send their names, organizations and e-mail addresses to vsaper@wnj.com and we will add them to our mailing list.

For more information, please contact your WN&J attorney or Vern Saper at 616.752.2116

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