

New South Chapter of the ESOP Association
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How 401(k)s and ESOPs Work Together

Rita Wilson Harris
Greenberg Farrow
Architecture
Incorporated
GreenbergFarrow

Susan Petrirena
Swerdlin & Company



Lisa Durham
Krieg DeVault LLP



Topics to be Covered

- ▶ Administration Issues between ESOP and 401(k)
- ▶ Making the Match in the ESOP
- ▶ Deduction Limits of 401(k) and ESOP
- ▶ Testing Requirements in 401(k) and ESOP
- ▶ Comparing KSOP to Separate 401(k) and ESOP
- ▶ Using 401(k) Assets in ESOP Transactions



Administration Issues

- ▶ Different participation eligibility requirements for different sources of funds (401(k), match, ESOP)
- ▶ Different distribution eligibility requirements for different sources of funds (can affect vested balance calculations)
- ▶ Diversification and segregation proceeds transferred to 401(k)



Recordkeeping Issues

- ▶ Not necessarily the “best of both worlds”
 - Some TPAs specialize in ESOP administration
 - Many TPAs specialize in 401(k) daily valuation administration
 - Few specialize in both and offer flexibility of investments
 - Ask your other service providers for suggestions



Recordkeeping Issues

- ▶ Phase 1 – 401(k) on one reporting platform & ESOP on another
 - Myriad of issues –
 - Liquidation/Diversification Provisions
 - Not recommended
- ▶ Final – 401(k) & ESOP on one platform
 - Streamlined plan administration
 - Reduced costs
 - More effective retirement planning for plan participants



Matching Contributions

- ▶ Use matching contributions to ESOP as an incentive for participants to make 401(k) deferrals.
- ▶ Does not necessarily increase benefit cost to employer, just converts pro-rata allocations to a match formula.
- ▶ Could be set up as a safe harbor allocation to avoid ADP and ACP testing in 401(k) plan.



Matching Contributions

- ▶ “Safe Harbor” 401(k) – Eliminates the need to perform either the ADP or ACP test. These types of plans must:
 - Contribute 3% of compensation to all eligible Non-HCEs; or
 - Contribute a matching contribution on behalf of Non-HCEs on a dollar-for-dollar basis up to 3% of compensation; plus 50% of the next 2% of compensation that is deferred by the participant.
- ▶ Safe Harbor contributions must be fully vested and are subject to the same restrictions on in-service distributions that apply to 401(k) deferrals.

Matching Contributions

- ▶ 401(k) Safe Harbor Match
 - Match in stock or cash
 - Allowed company to use cash for RPO & match in shares
 - Will help with the have/have nots for mature ESOP companies



Matching Contributions in ESOP

- ▶ Increased administrative costs
 - Need to track additional sources of money
 - Need to perform ACP test within the ESOP
 - Complexity added to share release calculation



Matching Contributions in ESOP

▶ Benefits

- Matching contributions promote greater overall participant retirement benefits due to increased participation in 401(k) plan.
- Highly compensated employees (“HCEs”) may be allowed to defer more within 401(k) plan due to increased participation by Non-HCEs (still need to watch 415 limit).
- Greater percentage of ESOP contribution allocated to participants who perceive the ESOP as a great benefit.



ESOP Matching Contributions Example

- ▶ Allocation of shares released when match and regular contributions used to fund payments
- ▶ Assumptions:
 - The loan payment for the year was \$100,000.
 - \$50,000 match contributions and \$50,000 regular contributions used to fund loan payment
 - Through share release formula 1,000 shares released with a value of \$80 per share (total value of released shares equal to \$80,000).



ESOP Matching Contributions – Scenario #1

- ▶ Apply the released shares on a pro-rata basis of the contributions used to fund the loan payments.
 - Value of Match Allocation = \$40,000
[\$50,000 / \$100,000 * 1,000 shares * \$80 per share]
 - Value of Stock Bonus Allocation = \$40,000
[\$50,000 / \$100,000 * 1,000 shares * \$80 per share]

ESOP Matching Contributions – Scenario #2

- ▶ Apply released shares with fair market value equal to matching contributions first to matching source with remainder allocated to the regular contribution source
 - Allocated to Match \$50,000 [625 shares * \$80 per share]
 - Allocated to Stock Bonus \$30,000 [375 shares * \$80 per share]
 - Be careful setting this precedent



Testing Requirements

- ▶ 401(k) and ESOP must be aggregated for:
 - Code Section 415 – Maximum annual additions
 - Code Section 404 – Maximum deductible contribution
 - Code Section 414(q) – Determination of HCEs must be consistently applied to all plans
 - Code Section 401(a)(10) and 416 – Top heavy testing

Testing Requirements

- ▶ 401(k) and ESOP must be tested separately for:
 - Code Section 401(a)(3) and 410(b) – Minimum coverage requirements
 - Non-discrimination requirements of Code Section 401(k) (employee elective deferrals) and Code 401(m) (employer matching contributions)
 - However, if matching contributions are made in both 401(k) and ESOP, they can be aggregated for Code Section 401(m) testing

Maximum Deductible Contribution

- ▶ Code Section 404(a)
 - 25% of eligible compensation
 - 401(k) elective contributions are not treated as employer contributions for deduction purposes.
 - Generally applies to 401(k) and ESOP together, but may be able to apply separate deductible limits under certain circumstances



Maximum Deductible Contribution

- ▶ Code Section 404 provides that a contribution that cannot be allocated under Code Section 415 cannot be deducted under Code Section 404.
- ▶ Code Section 415
 - The maximum annual additions any one participant may receive is the lesser of:
 - 100% of eligible compensation; or
 - \$49,000 in 2011 (indexed for inflation in increments of \$1,000)



KSOP Comparisons

Definition of a KSOP

- ▶ A qualified retirement plan with both an ESOP component and a 401(k) component
 - ESOP component (could be matching contributions) is designed to be primarily invested in employer stock.
 - 401(k) component (could contain other sources of money such as matching, profit sharing or rollover) may be partially invested in employer stock or not at all.



KSOP Comparisons

- ▶ 401(k) Plan with a company stock fund (no ESOP)
 - One plan document
 - One Form 5500 filing requirement
 - One audit requirement if more than 100 participants
 - One summary annual report
 - One summary plan description
 - Subject to reporting & disclosure if 401(k) deferrals invested in stock
 - Plan cannot be leveraged
 - No potential deduction for C-corp dividends

KSOP Comparisons

- ▶ Separate 401(k) Plan and Separate ESOP
 - Two plan documents
 - Two Form 5500 filing requirements
 - Two audit requirements if more than 100 participants
 - Two summary annual reports
 - Two summary plan descriptions
 - Administration of plans generally done separately
 - Certain compliance tests need to be performed on a combined plan basis



KSOP Comparisons

- ▶ KSOP
- ▶ Pros:
 - One plan document containing 401(k) and ESOP provisions
 - One Form 5500 filing requirement
 - One audit requirement
 - One summary annual report
 - One summary plan description
 - One definition of compensation (401k prototype plan is not as flexible in compensation definitions)
 - Amendments to one plan
 - Administration of plan performed on a combined plan basis, if possible



KSOP Comparisons

- ▶ KSOP
- ▶ Cons:
 - Combine components for mandatory cashout
 - May have to count years of participation in 401(k) plan for ESOP diversification purposes
 - Must coordinate distributions for NUA treatment
 - If publicly traded, must provide PPA diversification

Investment of 401(k) Assets in Employer Stock

- ▶ An ESOP, KSOP or a 401(k) plan may allow participants to voluntarily invest 401(k) assets in employer stock.
- ▶ In a 401(k) plan, employer stock is another investment option.
- ▶ In a KSOP, 401(k) assets are transferred to the ESOP component.
- ▶ In an ESOP, 401(k) assets are transferred in a plan-to-plan transfer to the ESOP.
- ▶ Which is better?



Registration and Disclosure Requirements

- ▶ Registration – filing of documents with the Securities and Exchange Commission and state agencies.
 - Could be a one-time requirement or ongoing depending on how often participants are allowed to elect to invest in employer stock.
 - Not all situations involving the elective investment of non-ESOP funds in employer stock require registration.
- ▶ Disclosure – required in situations where registration is not required.
 - Similar to prospectus information, although less detailed.



Financing Uses of Non-ESOP Plan Assets

- ▶ Purchase of a subsidiary or an entire company by a newly created company.
- ▶ Assumptions:
 - Corporation A is willing to sell Subsidiary B.
 - The employees of Subsidiary B want to purchase B.
 - B's employees are participants in the retirement plan of A.
 - A's retirement plan allows for distribution immediately after termination of employment.

Financing Uses of Non-ESOP Plan Assets

- ▶ Steps:
 - Former Employees of B set up NewCo.
 - NewCo implements ESOP that accepts rollover contributions.
 - Former employees of B (now NewCo employees) voluntarily roll over distributions from A's retirement plan to NewCo ESOP.
 - Rollover proceeds used to purchase stock.



Questions?

Rita Wilson Harris
Greenberg Farrow Architecture
Incorporated
1430 West Peachtree St., NW
Suite 200
Atlanta, GA 30309
(404) 601-3941
rharris@greenbergfarrow.com

GreenbergFarrow

Lisa A. Durham
Krieg DeVault LLP
1230 Peachtree St., NE
Suite 2490
Atlanta, GA 30309
(678) 608-4127
ldurham@kdlegal.com



Susan Petirena
Swerdlin & Company
5901 Peachtree
Dunwoody Road
Building B, Suite 170
Atlanta, GA 30328
(678-775-5527)
spetirena@swerdlin.net



