ESOP BRIEF # 8

The KSOP - ESOPs and 401(k) Plans

By The ESOP Association

A summary of how ESOPs and 401(k) plans can work together to benefit the employee owner and the employer.

Financial managers readily recognize the possible corporate benefits of an ESOP loan; lower interest costs, tax deductibility of principal and interest payments, the use of corporate contributions to repay existing debt, potential use of dividends to retire a loan, etc. In addition, combining an ESOP with a 401(k) plan (KSOP) may result in increased plan benefits to the employees and a lower plan costs to the employer.

The Benefits of KSOPs

From the company's benefit perspective, there is often an opportunity to provide an increased benefit at minor cost to the company. If even a portion of the tax savings generated by the ESOPs is applied to the benefits program, employees will see an increase in their benefit level. This might take the form of an increase 401(k) matching contribution or an increase or addition in some other area.

If a block of stock is to be purchased thorough the ESOP component of the KSOP (the common term applied to 401(K)/ESOP combinations), then it may be possible to offer a significant increase in the matching contribution. This in turn will create a higher participation level among lower paid employees allowing, in turn, the highly compensated employees to make larger deferrals in the 401(k). Repaying ESOP loans with the company's matching contribution may boost enthusiasm, because it:

1. Gives employees larger equity stake in the company
2. Often means an increase in the matching contribution.

From a corporate finance perspective, it becomes very obvious early in the analysis of most situations that KSOP loans are attractive.

Making KSOPs ever more attractive to employers and employees are the positive new tax laws governing the amounts employers and employees may contribute to KSOP arrangements beginning in 2002.

Corporate Disadvantage?

Increased matching may appear to be an increased cost, but if the corporation had planned to make a contribution to the ESOP, a "no cost" match is made possible as long as the match is earmarked for the purchase of employer securities or the repayment of a portion of an ESOP loan. The amount of the 401(k) match is subtracted from the planned contribution, added to the employee accounts and then added back to the ESOP funds.

Since the majority of 401(k) plans already provide employer match, chances are this approach will actually reduce a portion of the corporation's benefits costs or would allow other benefit levels to be increased at no additional cost.

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