Five Misconceptions about ESOPs Relationship with 401(k) Plans

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Most companies offer 401(k) tax deferred savings plans for employees, and most of the companies that offer 401(k) plans offer a company match for a certain % of employees' savings; e.g., the company will contribute ½% to an employee's 401(k) for each 1% of pay deferred by the employee up to a maximum company contribution of 3%. The 401(k) is a qualified retirement plan. Employee Stock Ownership Plans (ESOPs) are also qualified retirement plans. Lately, we have noticed some misconceptions about the interaction of ESOPs and 401(k).

MISCONCEPTION #1: If my company establishes an ESOP, that means the company must discontinue the 401(k) plan.

That is false. A company can have both an ESOP and a 401(k) Plan.

MISCONCEPTION #2: If my company establishes an ESOP, that means the company must discontinue its company match within the 401(k) Plan.

That is false. There is no requirement that a company must discontinue its company match within the 401(k) if it establishes an ESOP. However, many companies make the discretionary decision that the ESOP will become the company's primary retirement vehicle, so the company will be concentrating its retirement contributions in the ESOP and, therefore, will be discontinuing or reducing the company match within the 401(k). An additional factor is that when the company is paying off the loan used to purchased shares by the ESOP, this greatly constricts cash flow. After the loan is repaid, many companies re-start the match into the 401(k) Plan, although it is often at a lower amount, since ESOP contributions are still needed for repurchase obligation funding. Finally, in cases where the company revises its 401(k) Plan so that the company match is eliminated, typically the company has the discretion to put in a company match for a given year if the company's financial condition allows it to do so.

MISCONCEPTION #3: My company has both an ESOP and a 401(k) Plan, but they are separate plans and have no interrelationship with one another.

That is false. There is a requirement that the combined company contribution for all retirement plans to employees' retirement accounts cannot generally exceed 25% of eligible payroll. Company contributions to both the ESOP and 401(k) Plans are taken into account in determining whether or not a company complies with this requirement. Additionally, the law limits the amount of 401(k) deferrals, company contributions, and reallocated forfeitures any individual participant can receive under all of the retirement plans an employer sponsors, and the 401(k) and ESOP are tested together for this limit.

MISCONCEPTION #4: My company has a K-SOP in which one of my investment choices for my payroll deferral is to buy company stock in the ESOP. The ESOP's vesting schedule is the 6-year graded schedule. I've been with the company only 3 years. I'm irritated that I'm not 100% vested in shares that I am purchasing with my own money.

Don't be irritated. While this comment cannot be stated with certainty, your ESOP Plan should state that ESOP participants who purchase ESOP shares through the K-SOP are 100% vested immediately in those shares.

MISCONCEPTION #5: Extending #4 above, my ESOP Plan does say that ESOP participants who purchase ESOP shares through the K-SOP are 100% vested immediately in those shares. That means I'm 100% vested immediately in the company match in my 401(k) which is in the form of ESOP shares of stock.

No. In most cases, since the shares in your 401(k) company match were provided by the company and were NOT directly purchased by you, the ESOP's normal vesting schedule applies to those shares. You are not 100% vested immediately in ESOP shares in your 401(k) company match.

This article was reviewed by Pete Shuler, Partner in the Columbus OH office of the CPA and ESOP administration firm of Crowe Horwath LLP. However, nothing in this article should be construed to be legal or tax advice or opinion. For answers to specific questions, consult your ESOP professional. OAW