Limits on ESOP Contributions

The ESOP Association

IRS Section 404 and 415

Background

Although Congress authorized the creation of ESOPs in the Employee Retirement Income Security Act of 1974 (ERISA), ESOPs are not singularly a retirement plan for their participants. In fact, Sen. Russell Long, then the Chairman of the Senate Finance Committee and a champion for the creation of ESOPs, claimed that ESOPs would be a "Geritol" for the economy during a period when bank financing for companies was difficult to obtain. The Tax Reform Act of 1984 reiterated the importance of ESOPs to the broader economy and included provisions to enhance ESOP participation. In their descriptive summary of the bill, the report from the Congressional Joint Committee on Taxation categorized the ESOP provisions of the bill as "Incentives for Investment and Continued Economic Growth."[1]

ESOPs allow workers to be the owners of their enterprise. They reduce the historic friction between owners and workers, align incentives for both, and allow workers to have a real stake in the entire company rather than only their own narrow area of production. ESOPs are a tool for societal change and a way for companies to outlive their founders and avoid the whims and winds of investors who may be limited by strictly financial interests rather than the broader interests of the company's workers and other stakeholders. Yes, ESOPs are a retirement vehicle, but they are much more than that. ESOPs offer significant additional societal benefits above those of any other defined contribution retirement plan type.

Action Items

Unfortunately, sections 404 and 415 of the tax code lump ESOP plan participants in with all other defined contribution retirement plan accounts and limit the amount of beneficial ownership that can be accrued by ESOP participants. If the annual limits imposed by sections 404 and 415 are exceeded an ESOP and/or ESOP plan participant must reduce savings in their 401(k) or other defined contribution account so as not to exceed the limit. The public policy purpose of the statutory limit seems to be fiscal in nature (limiting the cost to the US Treasury of the tax benefit) while limiting the ability of workers to secure their future in retirement. With respect to ESOP participants in particular, these limits force companies to withhold contributions to ESOP participant accounts or to reduce contributions to other defined contribution plans. As ESOPs provide multiple societal benefits distinct from those provided by any other type of defined contribution plan, Congress should consider providing relief from the annual contribution limits in Sec. 404 and 415.

Continued on the Back >

[1]Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84.

LEARN MORE ABOUT TEA ADVOCACY AT
esopassociation.org/advocacy

POINT OF CONTACT
Greg Facchiano
Vice President of Government Relations and Public Affairs
gfacchiano@esopassociation.org
202-293-6268

Code Section 404

Code Section 404 applies limits to *employers*. The section allows plan sponsors to make deductible contributions to the qualified retirement plans they sponsor; in general, these contributions cannot exceed 25% of eligible compensation. Eligible compensation refers only to the compensation given to participants receiving an employer contribution. For 2022, this limit has been increased to $305,000.

Employer contributions that count toward the 25% limit include:

- Employer matching contributions.
- Employer safe harbor contributions (non-elective and matching).
- Employer discretionary contributions.
- Employer money purchase contributions.
- Prevailing wage contributions.
- Cash contributions in an ESOP and stock contributions in an ESOP (valued at the fair market value on the last day of the plan year).
- Contributions to fund ESOP loan payments. (For C-corporations, this applies only to payments on principal; for S-corporations, this applies to principal and interest payments.)

Contributions exceeding the maximum allowable amount are subject to a 10% excise tax, and any excesses must be included in the deduction limits in the following plan year.

Code Section 415

Code Section 415 applies limits to *employees* on how much money they can contribute to their own tax deferred retirement accounts – including the amounts provided to their accounts from their employers.

The maximum annual allowable contribution is the lesser of 100% of a participant's compensation, or $61,000 for 2022.

Annual contributions calculated toward the cap include the following:

- Employee 401(k) deferrals, not including catch-up contributions.
- Employee Roth deferrals, not including catch-up contributions.
- Employee after-tax contributions to a qualified plan.
- Employer matching contributions.
- Employer safe harbor contributions (non-elective and matching).
- Employer discretionary contributions.
- Employer money purchase contributions.
- Prevailing wage contributions
- Reallocated forfeitures, other than to the ESOP.
- Cash and stock contributions made to an ESOP.
- Contributions to fund ESOP loan payments. (For C-corporations, this applies only to payments on principal, provided that highly compensated employees (HCEs)[2] do not receive more than one third of the allocation. For S-corporations, this applies to payments on both principal and interest.)
- ESOP reallocated forfeitures, which are valued at the fair market value on the last day of the plan year. (For C-corporations, forfeitures related to leveraged shares may be excluded if HCEs don't receive more than one third of the allocation. For S-corporations, these forfeitures include the value of the stock reallocated, plus the cash reallocated.

Continued >

[2]HCEs are defined as individuals whose compensation exceeded the threshold in the prior year—$135,000 for 2021, who have direct ownership in excess of 5% in the current or prior plan year, or who are certain lineal ascendants and descendants of the individuals described above.

Summary and Policy Prescription

The net effect for the employee owners of ESOP companies of Sections 404 and 415 is to limit the total amount they can save for their retirement. Indeed, this limits them to same amount they could have saved if they were not ESOP participants and merely participants in their employer's 401(k) or other similar retirement plan. From a practical perspective, when a 415 limit is exceeded a plan participant often must remove previously made contributions from their 401(k) or similar account and retroactively pay tax on an amount necessary to bring their overall retirement savings into compliance.

This restriction is inconsistent with the broader objective of ESOP policy to provide ownership of companies to employees and eliminate the historical misalignment of incentives and objectives of capital and labor.

The tax benefits of ESOP ownership (tax deferral) are similar to the tax benefits utilized by more traditional capital providers (i.e. capital gains tax rates, tax avoidance using bank lending against equity assets, carried interest deductions, etc.). Unlike traditional capital providers, however, ESOP plan participants are limited by Sections 404 and 415 in the *amount* that they can save or invest – even though these investments are largely limited to be of benefit in retirement.

Amending the tax code to remove ESOP plans and plan participant contributions from calculations under sections 404 and 415, will eliminate the disincentive for ESOP participation and the limitation on ESOP participants from fully utilizing their other defined contribution retirement plan options.