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Capital Notes

Should the ESOP or the Company Pay Plan-Related Expenses?

As a general rule, costs associated with plan administration are deductible to the sponsoring corporation. From a taxation perspective, there is usually no difference between running expenses through the plan or through the company. Expenses paid through the plan do count in the IRC 404 deduction limit, thus reducing the 25% of eligible pay as the contribution cap, which could matter to small plans looking for maximum contributions.

Plan expenses, which can legitimately include such items as the independent appraisal, annual plan administration and audit (if needed), do reduce the benefit to participants from company contributions to the plan. Legal fees associated with a transaction cannot be a plan expense. We recommend that the corporation pay the costs in nearly all instances.

In 2003, the Employee Benefit Security Agency of the Department of Labor released Field Assistance Bulletin 2003-3. This bulletin provided guidelines as to when expenses can be charged to a retirement plan – and even when expenses can be charged against the accounts of individual participants. For example, the legal expense of reviewing a QDRO can now be charged to the affected individual participant's account. Reasonable charges can also be made to affected participants for the calculation of benefits payable under various distribution options or to process hardship withdrawals and participant loans – this could happen if the plan administrator incurred unique costs in this regard. The charges must be reasonable. This Field Assistance Bulletin is considerably more favorable to the employer passing along appropriate expenses to the plan than was the ERISA Opinion Letter No. 94-32A. The latter is expressly superseded by the 2003 bulletin.

In 2004, the IRS released Revenue Ruling 2004-10, which permits a plan to apply a reasonable charge to the accounts of terminated participants who leave their accounts with the plan. It is not necessary that such a charge be made against the accounts of active participants, although terminated participants cannot be required to bear the expenses attributable to active participant accounts. This practice is also permitted by Field Assistance Bulletin 2003-3. Some of our clients have been interested in adopting such a practice with respect to the accounts of participants who are no longer employees. Charges may now be applied with appropriate provisions in the governing plan documents.

The largest plan expenses for an ESOP are the actual stock purchases and then, the long term emerging stock repurchases from departing plan participants with vested and payable account balances. The company pays the original stock acquisition costs. The funding of the later ESOP stock buyback obligations can be either directly from the company (not deductible) or through the plan (deductible to the sponsor). The discussion of who should pay these latter long term costs goes beyond the scope of this short note. Again, in general, have the company pay the administration costs and let the ESOP contributions be a pure benefit to the participants.