

KELLY, HANNAFORD & BATTLES P.A.

ATTORNEYS AT LAW

3900 CAMPBELL MITHUN TOWER

222 SOUTH NINTH STREET

MINNEAPOLIS, MINNESOTA 55402

TELEPHONE (612) 341-0881

FACSIMILE (612) 341-1041

ANTHONY R. BATTLES  
JULE M. HANNAFORD IV  
A. DAVID KELLY  
JOHN W. HAINE

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MARK D. MEYER  
OF COUNSEL

WRITER'S DIRECT DIAL:  
612/455-6075  
DKelly@KHBlaw.com

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**Re: New Proposed 401(k)/(m) Regulations as Applicable to Plans with an ESOP Component**

Dear Clients and Other Friends:

On July 17, the IRS proposed a rewrite of the Code § 401(k) and (m) regulations. Most of the changes made by the proposal involve updating the regulations to deal with various recent law changes. However, the proposal does make one significant substantive change which we think will be very helpful in cases where a 401(k) plan includes an Employee Stock Ownership Plan component.

Many employers that allow investment of employer match or employee contributions in company stock have found it helpful to characterize the plan (or part of it) as an ESOP so that dividends on the shares of company stock will be tax deductible. Under the existing 401(k)/(m) regulations, such plans were confronted with unusually complex rules for running the 401(k) actual deferral percentage ("ADP") test and the 401(m) actual contribution percentage ("ACP") test because the ESOP component of a plan had to be tested separately from the non-ESOP portion. For example, if a plan gave each participant a choice whether to invest new 401(k) deposits in company stock in the plan's ESOP component or in other investments through its profit sharing component, the ESOP contributions would have to be tested separately from the profit sharing. Practitioners found a variety of ways to minimize this complexity. For example, here at Kelly, Hannaford and Battles our preferred solution was to call the whole plan an ESOP even though a significant portion of the money was invested in other investments. Another approach used by some practitioners was to briefly hold all of the contributions in non-ESOP investments so that the entire plan could be tested as profit sharing and then transfer the contributions out of profit sharing to ESOP for participants who wanted company stock.

The proposed regulations will allow employers to test the ESOP and profit sharing components of a 401(k) plan together for purposes of the ADP and ACP tests. This will allow employers to eliminate some of the complexities that resulted from the old regulations and to more accurately characterize the different components of a given plan (i.e., all investments in company stock can be in the ESOP and all other investments can be profit sharing).

We think the above change will be helpful to employers who already have an ESOP component in their 401(k) plans. Also, there may be some cases where an employer has thought about converting part of a 401(k) plan to ESOP so that dividends on employer stock would be

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tax deductible but has been reluctant to actually make the change because of the testing complexities. Now that some of these complexities are being eliminated, such employers may want to reconsider and add an ESOP component.

No action is required in response to the proposed regulations. However, if you:

- Maintain an ESOP and have employed complex means to deal with the ADP and/or ACP testing problem, or
- Have been reluctant to take advantage of the ESOP dividend deduction due to the testing problem,

this would be a good time to start thinking about how and when you might take advantage of this new approach to ESOP plan components.

Please let us know if you have any questions.

Very truly yours,

A. David Kelly

ADK/hgn