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IRS Proposes Diversification Rules for Defined Contribution Plans Holding Publicly Traded Employer Securities

The IRS has issued proposed regulations, providing guidance and extending certain transitional relief with respect to the diversification requirements for defined contribution plans holding publicly traded employer securities added by the Pension Protection Act of 2006.

Background

The Pension Protection Act of 2006 (PPA) added Section 401(a)(35) to the Internal Revenue Code, imposing diversification requirements on certain defined contribution plans holding publicly traded employer securities, generally effective for plan years beginning in 2007 (with a deferred effective date for certain collectively bargained plans). To remain qualified, plans (other than certain stand-alone ESOPs and one-participant retirement plans) must allow participants, alternate payees and beneficiaries to divest publicly-traded employer securities in their accounts and reinvest those amounts in other investment options at least quarterly.

In Notice 2006-107, the IRS provided guidance on the new diversification requirements, including limited transition relief to allow plans to remove restrictions or conditions on the diversification of employer securities that are not imposed on other plan investments. (See our December 6, 2006 *For Your Information*.) The notice clarified that the diversification requirements did not apply to employer securities held through either an investment company registered under the Investment Company Act of 1940 or through a similar regulated pooled investment vehicle with diversified holdings. The notice also provided transition relief through 2007 for plan provisions in effect on December 18, 2006 that did not impose restrictions on a stable value fund or permitted less frequent divestitures of employer securities than were allowed for other investments, as long as the other investments were not generally available (e.g., only available to a fixed class of participants). Last month, the IRS issued Notice 2008-7 extending this transition relief for grandfathered investments until final regulations go into effect.

The IRS has now issued proposed regulations implementing the new employer stock diversification requirements, generally effective for plan years beginning in 2009. The regulations incorporate much of the guidance in Notice 2006-107, extend and expand the transition relief for stable value funds and define when employer securities would be deemed to be publicly traded for purposes of the diversification requirements.

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Proposed Regulations

Publicly Traded Securities

Defined contribution plans holding publicly traded employer securities (i.e., applicable defined contribution plans) are generally subject to the new diversification requirements. The regulations provide that only employer securities under ERISA Section 407(d)(1) that are "readily tradable on an established securities market" are considered publicly traded employer securities for these purposes and provide separate rules for determining whether stock on domestic and foreign securities exchanges are readily tradable.

The regulations also incorporate the PPA provision requiring a plan holding employer securities that are not publicly traded (e.g., a tracking stock related to the performance of a subsidiary of a public company) to nonetheless be treated as holding publicly traded employer securities if any member of a controlled group which includes the employer (determined by applying Section 1563(a) but substituting 50% for 80%) has issued a class of stock that is a publicly traded employer security.

Diversification Rights

The proposed regulations incorporate the PPA rules and guidance in Notice 2006-107 on basic divestment and reinvestment rights for investments in employer securities, which generally attach to employee contributions and elective deferrals immediately, and to employer contributions after three years of service. The regulations provide additional guidance with respect to the three-year requirement. For plans that credit service for vesting under the elapsed time method or provide for immediate vesting, participants will be deemed to complete three years of service on the third anniversary of their respective hire dates. For plans using a vesting computation period, participants will complete three years of service immediately following the end of the third vesting computation period.

The regulations incorporate the PPA provision requiring a plan to allow individuals to diversify at least quarterly. For this purpose, they would require plans to provide no less than three diversified investment options with materially different risk and return characteristics.

Exemptions from Diversification Requirements

As in Notice 2006-107, the proposed regulations would exempt both stand-alone ESOPs that hold no contributions (or earnings) subject to Sections 401(k) or (m) and one-participant retirement plans, as well as certain types of pooled investments from diversification requirements. The regulations clarify that an ESOP would not lose this exemption by receiving rollover contributions from another plan, even if those amounts were attributable to contributions subject to Sections 401(k) or 401(m) in the other plan.

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The proposed regulations would also exempt plans holding employer securities as part of an investment vehicle held either by a registered investment company or a similar pooled investment vehicle, as long as their holdings are diversified sufficiently to minimize the risk of large losses. For exemption purposes, a pooled investment vehicle is a common or collective trust fund or pooled investment fund maintained by a state or federally regulated bank or trust company, a pooled investment fund of an insurance company qualified to do business in a state, or an investment fund designated by the IRS. Like Notice 2006-107, the exemptions under the regulations would extend only to pooled investment funds with stated investment objectives and to investments that are independent of both the employer and its affiliates. To ensure a pooled fund investment is not an attempt to evade diversification requirements, the regulations limit employer securities held by these pooled funds to no more than 10% of the fund's total investment value.

Permissible Restrictions and Conditions

As under previous guidance, the proposed regulations would generally prohibit direct and indirect restrictions on divesting investments in employer securities that are not imposed on other investments and provisions that condition direct or indirect benefits on the investment in employer securities (e.g., higher company match percentage for investments in employer securities). However, the regulations would permit a plan to allow for more frequent transfers to a stable value or similar fund than to other investments, thus effectively making prior transition relief permanent.

As in Notice 2006-107, the regulations would allow restrictions on diversification that are reasonably designed to comply with securities law (e.g., a smaller entity's restriction of divestitures to once a quarter), even if it is broader than the minimum needed to comply with those laws. The regulations would provide relief from the diversification requirements for the first 90 days after the plan becomes subject to them (e.g., when another entity in the controlled group first issues publicly traded stock or when an ESOP first provides for contributions that are subject to Section 401(k) or Section 401(m). Earlier guidance measured the 90-day period from the date of the initial public offering.

The proposed regulations would also allow certain other restrictions on and benefits from investments in employer securities (e.g., capping investment in employer securities at 10% of the participant's account balance or freezing further investment altogether). Unlike Notice 2006-107, the regulations would permit reasonable restrictions on the timing and number of investment elections a participant could make to invest in employer securities, as long as the limitations were designed to restrict short-term trading. Thus, a plan could limit a participant's purchase of employer securities within a reasonable period after his sale of securities (e.g., seven days) without violating the new diversification requirements.

The proposed regulations provide that plans may impose fees on other investment options that are not imposed on employer securities. They would also allow the imposition of reasonable fees for divesting employer securities.

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Effective Date

The regulations are proposed to take effect for plan years beginning in 2009. Until the final regulations go into effect, plans can rely on the proposed regulations or meet the requirements of Notice 2006-107 with the expanded transition relief provided in Notice 2008-7 for stable value funds.

Conclusion

Although the proposed regulations generally include guidance that was issued previously, they provide some useful new guidance on meeting the diversification requirements.

Buck's consultants would be pleased to assist you meet the PPA diversification requirements. We can also help you with required notices of diversification rights which, if not provided, can impose substantial penalties.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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