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Volume 33 | Issue 31 | June 9, 2010

IRS Issues Final Regulations on PPA Diversification Requirements

The IRS has released final regulations on the diversification requirements added by the Pension Protection Act of 2006 (PPA) for defined contribution plans holding publicly traded employer securities. The regulations apply for plan years beginning on or after January 1, 2011, but may be relied on immediately.

Background

PPA established new diversification requirements for defined contribution plans that include investments in publicly traded employer securities, generally effective for plan years beginning after December 31, 2006 (with a special effective date for collectively bargained plans). Defined contribution plans maintained by publicly traded companies (with the exception of certain stand-alone ESOPs that do not have contributions subject to Sections 401(k) or 401(m)) must permit plan participants and beneficiaries to divest contributions invested in employer securities and reinvest in other diversified investments no less frequently than quarterly. The plan must offer at least three investment options other than employer stock that have materially different risk and return characteristics. Further, the plan generally may not impose any restrictions or conditions on the diversification of the employer stock fund (other than those mandated by securities laws) that are not imposed on other investment options, nor can a plan condition benefits directly or indirectly on the participant investing in employer securities. The rules apply to participants' own contributions immediately upon investment. With respect to employer contributions, the diversification option must be made available to individuals who have completed at least three years of service.

In Notice 2006-107, the IRS provided limited transition relief to allow plans to remove restrictions or conditions on the diversification of employer securities that were not imposed on other plan investments. Notice 2008-7 extended this transition relief until final regulations go into effect. Proposed regulations on the diversification requirements were issued in January 2008. (See our January 31, 2008 *For Your Information*.) Notice 2009-97 extended the deadline for making plan amendments to comply with the requirements until the end of the plan year beginning in 2010.

The IRS has now issued final regulations that apply for plan years beginning on or after January 1, 2011. Although it is likely that most plans will already be in compliance with these regulations, plan sponsors should review their plans and ensure that any needed amendments are made by the end of the 2010 plan year.

The Final Regulations

The final regulations are largely similar to the proposed regulations, but include some clarifications.

Investment and Trading Restrictions

The final regulations incorporate previous guidance regarding permissible and impermissible restrictions and conditions on investments in employer securities, and confirm that these restrictions or conditions may be imposed directly or indirectly. Permissible restrictions include limitations on the percentage of employer stock in an account balance (e.g., 10%), reasonable restrictions on trading frequency (e.g., no reinvestment within 7 days of divestment), and fees on other investments or for divestment of employer stock. The regulations clarify that a plan may allow more frequent investments in a stable value or similar fund than in other funds, and more frequent transfers out of a qualified default investment alternative (QDIA) than a fund invested in employer securities.

Frozen Funds. Plans may prohibit investments in frozen employer securities funds, but only if no additional contributions or further investments in employer securities are allowed. The final regulations clarify that an employer securities fund would still be considered frozen even if dividends paid on the employer securities are reinvested in additional employer securities.

Leveraged ESOPs. The final regulations provide a transition rule for leveraged ESOPs, under which the employer stock fund would still be considered frozen when allocated employer securities are released to the fund as matching contributions from the plan's suspense account. However, this rule applies only if the securities were acquired in a plan year beginning prior to January 1, 2007 through an exempt loan that was not refinanced after the close of the last plan year beginning prior to January 1, 2007.

> ***BUCK COMMENT.*** *Notably, the IRS rejected a commentator's request to expand permissible indirect restrictions to include matching contributions invested in employer securities when participants have the right to divest these contributions and reinvest in other funds, but are not permitted to later reinvest in employer securities.*

Anti-Cutback Relief

Some ESOPs have historically satisfied the diversification requirement under Section 401(a)(28) by permitting the distribution of a portion of the participant's account within 90 days after the election period. Although this distribution option does not satisfy the diversification requirements in Section 401(a)(35), there has been some concern that its elimination would be a violation of the anti-cutback rules under Section 411(d)(6). In the preamble, the IRS states it will issue guidance permitting the elimination of the distribution option under Section 401(a)(28) with respect to an ESOP now subject to Section 401(a)(35) during the current extended remedial amendment period that expires on the last day of the first plan year that begins on or after January 1, 2010.

Certain Funds Not Treated as Holding "Publicly Traded" Employer Securities

The proposed regulations treated certain investment funds that include employer securities held indirectly through an investment company registered under the Investment Company Act of 1940 as "not holding employer securities." The final regulations define investment company for this purpose as "a regulated investment company under IRC Section 851(a)," thus extending the exception to stock held by exchange traded funds. Like the proposed regulations, the final regulations allow the IRS to designate other types of funds that may qualify for the exception.

The value of employer securities in these excepted funds cannot exceed 10 percent of the total value of the fund's investments. The final regulations provide that the 10 percent threshold is determined as of the end of the preceding plan year, and can be based on the latest disclosure of the funds' portfolio holdings filed with the SEC in that year (e.g., Form N-CSR, Certified Shareholder Report of Registered Management Investment Companies).

Once a fund exceeds the 10 percent limitation, the plan has 90 days to offer participants the right to divest themselves of investments in that fund.

Multiemployer Plans. For multiemployer plans, an investment option will not be treated as holding employer securities if the securities are held indirectly through an investment fund, as long as the value of the securities is not greater than 10 percent of all fund investments and the fund is managed by an investment manager independent of the employer. These types of investment funds include regulated investment companies as described in IRC Section 851(a) (e.g., certain exchange traded funds).

Effective Date

Although the regulations took effect on May 20, 2010, they are applicable for plan years beginning on or after January 1, 2011. In the interim, plans must comply with the statutory requirements, and may rely on Notice 2006-107, the proposed regulations, or the final regulations to satisfy them.

Conclusion

Sponsors, fiduciaries and administrators of 401(k) and other defined contribution pension plans that hold publicly traded employer securities should review and update their plan documents, communications and practices as appropriate. In particular, sponsors of plans that "froze" or placed other restrictions on employer securities investment funds should review their plan provisions for compliance with the final regulations. Plans affected by these regulations will have to adopt an interim or discretionary plan amendment by the last day of the plan year beginning on or after January 1, 2010 (December 31, 2010 for calendar year plans).

Buck's consultants would be pleased to discuss this latest guidance and its effect on your defined contribution plans with you.
