



Volume 34 | Issue 28 | March 28, 2011

IRS Extends the Diversification Regulations' Definition of "Readily Tradable on an Established Securities Market" to Other Code Sections

The terms "readily tradable on an established securities market" and "readily tradable on an established market" are used in various Code provisions dealing with employer securities. In 2010, the IRS issued final regulations defining "readily tradable on an established securities market" for purposes of the diversification requirements of Code Section 401(a)(35). In Notice 2011-19, the IRS provides that the definition in the diversification regulations also applies for other specified Code provisions that use that term or the similar term "readily tradable on an established market." Notice 2011-19's extension of the definition to other Code sections is generally effective for 2012 and later plan years. However, in the case of an employer with only common stock traded on a foreign market, the effective date of the Notice is delayed until 2013 plan years. In both situations, taxpayers may choose to rely on the Notice for periods after March 14, 2011.

Background

The Pension Protection Act of 2006 added a new Section 401(a)(35) to the Internal Revenue Code (Code), and a similar provision to the Employee Retirement Income Security Act of 1974 (ERISA), requiring most individual account plans that hold publicly traded employer securities to provide participants with an opportunity to diversify investments away from employer securities. Code Section 401(a)(35) defines a "publicly traded employer security" as an employer security that is "readily tradable on an established securities market." Neither the Code nor ERISA defines the term "readily tradable on an established securities market."

In 2010, the Department of the Treasury issued final regulations under Code Section 401(a)(35) (final diversification regulations). These regulations define "readily tradable on an established securities market" but only for purposes of Section 401(a)(35). (See our June 9, 2010 [For Your Information](#).) Under the final diversification regulations, employer securities are "readily tradable on an established securities market" if they are traded on a domestic or foreign exchange.

Employer securities are traded on a domestic exchange if they are traded on a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934 ('34 Act). Employer securities are traded on a foreign exchange if they are traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and where the securities are deemed by the Securities and

Exchange Commission (SEC) as having a ready market under SEC Rule 15c3-1. (Notice 2011-19 states that the SEC deems a security that is included on the FTSE Group All-World Index to have a ready market.)

BUCK COMMENT. *Prior to the adoption of the final diversification regulations, the IRS allowed plans to look to the definition of “publicly traded” under the IRS regulations governing prohibited transaction excise taxes for the meaning of “readily tradable on an established securities market.” Under those excise tax regulations, a security is “publicly traded” if it is traded on a domestic exchange or the security is quoted on a system sponsored by a national securities association registered under Section 15A(b) of the Securities Exchange Act (Exchange Act). The final diversification regulations did not refer to quote systems registered under Section 15A(b) of the Exchange Act because the quote system language was intended only to pick up NASDAQ and, in the interim, NASDAQ became registered under Section 6 of the ’34 Act.*

The preamble to the proposed diversification regulations made clear that securities traded on the Over the Counter Bulletin Board (OTCBB) and “pink slip” trades do not meet the definition of “readily tradable on an established securities market.” Neither the final diversification regulations nor Notice 2011-19 changed that position. Securities traded on a foreign exchange did not meet the definition of “publicly traded” under the IRS excise tax regulations.

In the final diversification regulations, the IRS asked for comments on whether the definition of “readily tradable on an established securities market” as used in those regulations should also be applied to other provisions of the Code that use the same term or the similar term “readily tradable on an established market.”

Notice 2011-19

Notice 2011-19 provides that the definition of “readily tradable on an established securities market” under the final diversification regulations shall apply to the following Code sections whether the section refers to “readily tradable on an established securities market” or “readily tradable on an established market”:

- Section 401(a)(22) (Voting Rights). This Code section provides that participants in a defined contribution plan (other than a profit sharing plan) must be given the voting rights associated with the employer securities held by the plan if the securities are not “readily tradable on an established market” and if more than 10% of the plan’s assets are employer securities.
- Section 401(a)(28)(C) (Independent Appraisal). This Code section requires an ESOP to use an independent appraiser to value all stock not “readily tradable on an established securities market.”
- Section 409(h)(1)(B) (Put Options). This Code section requires a plan that holds employer securities that are not “readily tradable on an established market” to provide employees with the right to “put” the securities to the employer for repurchase under a fair valuation formula.

- Section 409(l) (“Employer Securities”). For an ESOP, this Code section defines “employer securities” as common stock issued by the employer (or by another corporation that is a member of the employer’s controlled group, as specially defined) that is “readily tradable on an established securities market.” Several provisions of the Code cross-reference the Section 409(l) definition.
- Section 1042 (Qualified Replacement Property). This Code section provides that an employer that sells employer securities that are “readily tradable on an established securities market” to an employee stock ownership plan (ESOP) does not have to recognize the gain on the sale for tax purposes if the seller uses the proceeds to purchase qualified replacement property.

Effective Dates

The statutory diversification rules were generally effective for plan years beginning after December 31, 2006. The final diversification regulations were effective as of the first day of the 2011 plan year. Notice 2011-19 does not change the effective date of the final diversification regulations. For the other Code sections, Notice 2011-19 generally makes the definition of “readily tradable on an established securities market” and “readily tradable on an established market” effective beginning with the 2012 plan year. However, Notice 2011-19 is effective the first day of the 2013 plan year in the case of an employer and members of its controlled group that, after March 14, 2011, have (1) no common stock that is readily tradable on a domestic exchange, but (2) have common stock deemed by the SEC as readily tradable on a foreign exchange. Notwithstanding the above delayed effective dates, taxpayers may rely on the Notice definition for periods after March 14, 2011.

Conclusion

As most plans expected, the IRS has now said that the terms employer securities that are “readily tradable on an established securities market” and those “readily tradable on an established market” mean the same for all the cited Code provisions, and that meaning is the same as in the final diversification regulations.

Buck’s consultants are available to provide you with assistance in understanding how the expansion of the final diversification regulations’ definition to other Code provisions impacts your plans.

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.