Final Regulations on Diversification Requirements for Plans Holding Employer Securities

QPN Highlights

Action Required: Defined contribution plans with publicly traded employer stock investment options should check to make sure they are meeting the diversification requirements under Code Section 401(a)(35), including the participant notice requirement. The IRS sample participant notice is available on the Voya Sponsor Website.

- IRS has released final regulations covering participant rights to diversify their account holdings in employer stock. The regulations are effective for plan years beginning on and after January 1, 2011, but may be relied upon now.

- The employer stock diversification requirements were established under the Pension Protection Act of 2006 (PPA), which added Section 401(a)(35) to the Code.

- The final regulations incorporate previous guidance under Notice 2006-107 and clarify a number of technical points, as discussed below.

- Suggested Action Steps for affected plans are on page 4 of this QPN.

The Internal Revenue Service (IRS) has released final regulations under Internal Revenue Code (IRC) section 401(a)(35) covering the diversification requirements for defined contribution plans holding publicly traded employer securities. These may be viewed at http://edocket.access.gpo.gov/2010/2010-11924.htm.

Background – PPA added IRC section 401(a)(35), establishing diversification requirements for participant account balances invested in employer securities. Generally, defined contribution plans featuring publicly traded employer stock investment options must permit participants to divest their account holdings in employer stock and to reinvest those amounts in other investment options. Reinvestment must be permitted at reasonable intervals and no less frequently than quarterly.

Interim guidance was issued in November, 2006 under IRS Notice 2006-107 (see Qualified Plan News (QPN) 2007-3 – all QPNs are located on the Voya Sponsor Website), and through proposed regulations published in 2008 (see QPN 2008-7). The final regulations, summarized here, are substantially the same as the proposed regulations but include some clarifications.

Effective date - The effective date for IRC 401(a)(35) was for plan years beginning after December 31, 2006 (special effective dates apply to

Helpful Web Links

Voya 401(k) InfoCenter
Department of Labor
Department of Labor Compliance and Voluntary Correction Assistance
Taking the Mystery Out of Retirement Planning
Internal Revenue Service
Internal Revenue Service Correcting Plan Errors
collectively bargained plans, as well as certain ESOP arrangements). The effective date of these final regulations is for plan years beginning on or after January 1, 2011. For the period after the statutory effective date and before the effective date of these final regulations a plan is permitted to rely on Notice 2006-107, the proposed regulations, or these final regulations.

**Plans Subject to 401(a)(35) and the Final Regulations** - A defined contribution plan holding publicly traded securities is subject to the diversification requirements with the exception of stand-alone ESOP plans that hold no contributions subject to section 401(k) or 401(m) (relating to elective deferrals, after tax and matching contributions), and one-participant retirement plans. For this purpose an employer security is defined by reference to the Employee Retirement Income Security Act (ERISA) section 407(d)(1), which is a security issued by an employer of employees covered by the plan, or by an affiliate of such employer.

**Controlled groups** - In the case of a plan that holds employer securities that are not publicly traded, if any employer maintaining the plan or any member of the controlled group of corporations, of which the plan is a part, holds employer securities that are publicly traded then the plan will nevertheless be treated as holding publicly traded employer securities. For this purpose the definition of controlled group under IRC Section 1563(a) applies except that “50%” is substituted for “80%” when applying the stock ownership rules.

**Diversification Requirements for Contributions Invested in Employer Securities**

The diversification rules distinguish between (i) amounts attributable to elective deferrals, employee contributions or rollover contributions, and (ii) amounts attributable to employer contributions. Any participant, alternate payee, or beneficiary of a deceased participant, must be permitted to divest elective deferrals, employee contributions or rollover amounts at reasonable intervals no less frequently than quarterly. Divestment of any employer contributions invested in employer securities must be permitted once the participant has completed three years of service. An alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service must be permitted to diversify employer contributions, and a beneficiary of a deceased participant always has the right to diversify, even if the deceased participant never completed 3 years of service. Special transition rules apply to employer securities acquired in a plan year beginning before January 1, 2007.

**Investment Options** - The plan must offer at least three investment options, other than employer securities, where the proceeds of divested employer securities may be invested. Each of these options must be diversified and have materially different risk and return characteristics. This requirement will be met if the alternative investment options satisfy the Department of Labor Regulation for section 404(c), which provides the requirements for a participant in an individual account plan to exercise control over the assets in his account.

**Publicly Traded Security Defined** - Under IRC 401(a)(35)(G)(v) an employer security is publicly traded if it is readily tradable on an established securities market. The regulations provide separate rules for securities traded on domestic securities exchanges and foreign securities exchanges. A security is deemed to be readily tradable if it is traded on a securities exchange that is registered under section 6 of the Securities Exchange Act of 1934, which now includes the National Association of Securities Dealers (NASDAQ). Therefore, any security that does not fall under this definition would not be considered publicly traded for purposes of the diversification rights under 401(a)(35) unless it is traded on a foreign securities exchange. A foreign security is one that is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and the security is deemed as readily tradable by the Securities and Exchange Commission (SEC) as having a “ready market” under SEC Rule15c3-1.
Exemption for certain indirect investments - The final regulations provide that employer securities held by an investment company described in section 851(a) are not treated as being held by the plan. This exemption includes securities held indirectly through a) a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or Federal agency, b) a pooled investment fund of an insurance company that is qualified to do business in a State or c) an investment fund designated by the Commissioner in revenue rules, notices or other guidance published in the Internal Revenue Bulletin. Final regulations add to this list by providing that, under a multiemployer plan, the plan is not treated as holding employer securities if the securities are held indirectly through a fund managed by an investment manager.

For the exception to apply the investment fund that holds employer securities must have stated investment objectives and the investment must be independent of the employer and any affiliate of the employer. Further, if the employer securities held by the fund is more than 10% of the total value of all of the fund’s investments then the fund is not considered to be independent of the employer. The final regulations clarify that the 10% determination is made as of the end of the preceding plan year and can be based on the information in the latest disclosure of the fund’s portfolio holdings filed with the SEC in that preceding year.

Restrictions or Conditions on Investments in Employer Securities

Prohibition on restrictions or conditions - Restrictions or conditions on the investment of employer securities that are not imposed on the investment of other assets in the plan are prohibited. This rule applies to a direct or indirect restriction or condition on the individual’s rights to divest employer securities. A restriction or condition with respect to employer securities means a restriction on an individual’s right to divest an investment in employer securities that is not imposed on an investment that is not employer securities or a benefit that is conditioned on investment in employer securities.

Indirect restrictions or conditions - A plan imposes an indirect restriction on the individual’s right to divest employer securities if, for example the plan restricts the participant from reinvesting in employer securities for some period of time after the individual divests employer securities from his/her account balance. A plan is not imposing an indirect restriction or condition because there are tax consequences to the individuals when employer securities are divested. Similarly, the final regulations clarify that the plan is not imposing a condition or restriction if the plan does not permit an individual who divests employer securities to reinvest in the same employer securities but is permitted to invest the divested amount in another employer securities account under the plan (when certain conditions are met).

Permitted restrictions or conditions - The plan is permitted to impose a restriction or condition on the divestiture of employer securities that is required to or is reasonably designed to ensure compliance with applicable securities laws. In addition, a plan may restrict the right to divest employer securities for 90 days after first becoming subject to the employer stock diversification rules. The final regulation adds that a plan is not required to offer divestiture rights for 90 days after an investment fund under the plan no longer meets the requirements for being independent of the employer (including the requirement that employer securities held by the fund be no more than 10% of the total value of all of the fund’s investments).

Certain indirect restrictions or conditions permitted
- Although the final regulations generally prohibit indirect restrictions on the individual’s right to diversify, the rules do permit certain indirect restrictions and conditions on investment in employer securities.

Limit on investment, timing and fees - A plan would be permitted to limit the extent to which an individual’s account balance can be invested in employer securities, such as limiting the investment in employer securities to 10% of the individual’s account balance. The regulations clarify that a plan may impose reasonable restrictions on the timing
and number of investment elections an individual can make to invest in employer securities, provided that the restrictions are designed to limit short-term trading in the employer securities. In addition, the plan may impose fees on other investment options that are not imposed on the investment in employer securities and the plan may impose a reasonable fee for the divestment of employer securities.

Stable value and QDIA funds - A plan is permitted to allow transfers into or out of a stable value or similar fund more frequently than other funds under the plan, including employer securities, provided all other conditions are met. The final regulations clarify that for this purpose, a stable value or similar fund is one that is designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity. The final regulations also add that a plan may permit transfers out of a Qualified Default Investment Alternative (QDIA) more frequently than a fund invested in employer securities.

Frozen funds - The plan may terminate any further investment in employer securities, but only if the plan does not permit additional contributions or other investments to be invested in employer securities. For this purpose the final regulations clarify that the reinvestment of dividends on an employer security back into the employer security is not considered to be an additional investment in the fund, if that fund is the plan’s only employer stock fund.

ESOP plan exception - In addition, the final regulations provide transitional relief for certain leveraged employee stock ownership plans (ESOPs). These plans may allocate employer securities released as matching contributions from the plan’s suspense account that holds employer securities acquired with an exempt loan, back into the employer stock fund and the employer stock fund will still be considered a frozen fund (other conditions apply).

Action Steps for Employers – Plans that include investments in employer securities should be reviewed to confirm compliance with the diversification requirements. The following action steps are intended to assist employers with this task.

1. **Publicly traded stock** – Determine if the plan includes publicly traded stock as an investment option, as defined above.
2. **Restrictions or conditions** – Ensure that the plan complies with the rules regarding prohibited and permissible restrictions or conditions on the diversification of employer securities.
3. **Participant notice requirement** – If the plan does include publicly traded stock as defined above, participants must be notified of their right to diversify at least 30 days before they become eligible to exercise the right. As noted above, the right to diversify must be offered at least quarterly. Note that this is a one-time notice requirement, not an annual notice requirement.
   a. Since participants must be permitted to diversify elective deferrals and employee contributions immediately after they are made, participants must receive the notice at least 30 days before becoming eligible to diversify those contributions. Depending on the plan’s eligibility requirements and frequency of right to diversify, the employer may need to provide the diversification notice to employees at the time they are hired.
   b. If the plan includes employer contributions invested in employer stock participants who meet the 3 years of service requirement must again be given notice of their right to diversify those contributions at least 30 days before they become eligible to exercise this right.
   c. For this purpose the IRS provides sample notice language which is available on the Voya Sponsor Website.
4. **Exception to participant notice requirement** – If the plan provided for diversification rights prior to January 1, 2007, that are the same or more liberal than those described...
above the employer is not required to provide this notice.

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