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Internal Revenue Service Issues Final Regulations on Publicly-Traded Employer Securities Diversification

On May 19, 2010, the Internal Revenue Service ("IRS") published final regulations under Section 401(a)(35) of the Internal Revenue Code ("Code") (as added by the Pension Protection Act of 2006) regarding the diversification of investments required for defined contribution plans holding publicly-traded employer securities (other than stand-alone ESOPs or one participant retirement plans).

By way of background, employers and plan sponsors had previously relied on IRS Notice 2006-107 for guidance on diversification requirements until proposed regulations were issued in 2008. Although the new final regulations are similar to the proposed regulations of 2008, several areas have been expanded and offer additional guidance.

The final regulations are effective for plan years beginning on or after January 1, 2011. For plan years beginning prior to January 1, 2011 a plan may rely on IRS Notice 2006-107, the proposed regulations or the final regulations to satisfy Code Section 401(a)(35).

Plans Subject to Final Regulations.

The final regulations generally apply to an "applicable defined contribution plan," which means a defined contribution plan holding publicly-traded employer securities.

The proposed regulations of 2008 stated that plans holding publicly-traded employer securities are exempt from Code Section 401(a)(35) requirements under the following circumstances:

- The security was held in a broader fund of an investment company registered under the Investment Company Act of 1940; certain common or collective trust funds or pooled investment funds; certain funds designated by the IRS; and
- The investment was independent of the employer and the value of the security did not exceed 10 percent of the fund's value.

The final regulations replaced the reference to the "Investment Company Act of 1940" with "a regulated investment company as described in Code Section 851(a)" allowing for the exemption of exchange traded funds and also added the following clarifying points:

- Multiemployer plans will not be treated as holding publicly-traded employer securities as long as the securities are held indirectly through an independent investment fund managed by an investment manager that satisfies the 10 percent limit;
- An investment fund that fails to meet the 10 percent limit or rule or fails to be independent of the em-

employer will have 90 days to offer diversification rights to that investment; and

- The 10-percent limit will be based on the total value of the fund's investments as of the end of the preceding plan year.

Publicly-Traded Employer Securities.

The final regulations, like the proposed regulations of 2008, treat an employer security as "publicly-traded" if it is readily tradable on an established securities market. A plan that holds employer securities that are not publicly-traded will be subject to the diversification requirements only if an employer sponsoring the plan or any member of its controlled group (defined for this purpose as ownership of at least 50% of the total voting power or total value of the shares) has issued a class of stock which is publicly-traded (*i.e.*, utilizing the definition in Section 407 (d)(1) of the Employee Retirement Income Security Act of 1974, as amended).

Diversification. Defined contribution plans with investments in publicly-traded employer securities must provide diversification rights with respect to amounts invested in employer securities to continue to satisfy the plan qualification requirements of the Code. Such plans must permit "applicable individuals" to direct that the portion of his or her account that consists of publicly-traded employer securities be invested in alternative investments. "Applicable individuals" include: (i) any plan participant; and (ii) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

With regard to the portion of an account holding employer securities that was ac-

quired with employee contributions, the right to reinvest such funds in alternative investments must be provided immediately. With regard to employer contributions, a precondition of up to three years of service may be imposed for the right to reinvest such funds in alternative investments, except with regard to a beneficiary of a deceased participant. Furthermore, the opportunity to divest the employer securities and reinvest the equivalent amount in another investment must be provided at reasonable, periodic times occurring at least quarterly.

Prohibition on Restrictions. A plan may not impose restrictions or conditions with respect to the investment of publicly-traded employer securities that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of the application of securities laws). An example of such a prohibited restriction or condition would be a plan provision under which a participant who divests his or her account of employer securities will receive a less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities.

The final regulations, however, permit certain indirect restrictions and indirect conditions on investment in publicly-traded employer securities, such as a plan may: (i) limit the extent to which an account can be invested in employer securities (*e.g.*, prohibit the investment of additional amounts in employer securities where more than 10 percent of the individual's account is already invested in employer securities); (ii) impose fees on other investment options that are not imposed on the investment in employer securities; and (iii) impose a reasonable fee

for the divestment of employer securities.

The final regulations also clarify that: (i) upon freezing an employer security fund, a plan may allow for dividends to be reinvested in that fund; (ii) a plan may impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities if the restrictions are designed to limit short-term trading of the employer securities; and (iii) a plan may permit transfers in and out of a stable value or similar fund more frequently than other funds. The term “stable value fund or similar fund” is defined as an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity for benefit distributions or transfers to other qualified default investment alternatives (QDIA).

Also, a limited transitional rule is provided for the release of employer securities as matching contributions from a plan’s suspense account for certain leveraged ESOPs for publicly-traded employer securities that were acquired in a plan year beginning before January 1, 2007 with the proceeds of an exempt loan, which was not refinanced after the end of the last plan year beginning before January 1, 2007.

Additionally, an amendment to an ESOP that is subject to the Code Section 401(a)(35) diversification requirements that eliminates the distribution options available to participants to satisfy Code Section 401(a)(28) will not violate the anti-cutback rules. The final regulations indicate that further guidance will be issued soon with respect to this issue.

Comment. Employers, fiduciaries, and administrators of defined contribution plans that hold publicly-traded employer securities should review their plan documentation, communications and practices to ensure compliance with the final regulations. In particular, employers that “froze” their employer stock funds or placed other limits on participant investments should review those restrictions to be sure that the standards set forth in the final regulations are followed.

Furthermore, the Employee Retirement Income Security Act of 1974, as amended, requires an administrator to furnish notice to applicable individuals not later than 30 days before the first date on which such individual is eligible to exercise their right to divest publicly-traded employer securities. The notice must set forth the diversification rights and describe the importance of diversifying the investment of retirement account assets.

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