

Part III - Administrative, Procedural, and Miscellaneous

**Diversification Requirements for Qualified Defined Contribution Plans Holding Publicly Traded Employer Securities**

Notice 2006-107

I. PURPOSE

This notice provides transitional guidance on § 401(a)(35) of the Internal Revenue Code, added by section 901 of the Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780 (PPA '06), which provides diversification rights with respect to publicly traded employer securities held by a defined contribution plan. This notice also states that Treasury and the Service expect to issue regulations under § 401(a)(35) that incorporate the transitional relief in this notice and requests comments on the transitional guidance in this notice and on the topics that need to be addressed in the regulations.

II. BACKGROUND

Section 401(a)(35), as added by section 901 of PPA '06, provides that, to remain qualified under § 401(a), a defined contribution plan (other than certain employee stock ownership plans) must provide applicable individuals with the right to divest employer securities in their accounts and reinvest those amounts in certain diversified investments. Section 901 also added a parallel provision, section 204(j), to

the Employee Retirement Income Security Act of 1974 (ERISA).<sup>1</sup> In addition, section 101(m) of ERISA, as added by section 507 of PPA '06, requires a plan to provide applicable individuals with a notice describing diversification rights under section 204(j) of ERISA and providing information on the importance of diversifying investments.

The diversification requirements of § 401(a)(35) are generally effective with respect to plan years beginning after December 31, 2006, subject to certain special effective date rules, including a special rule with respect to plans maintained pursuant to a collective bargaining agreement. See section 901(c) of PPA '06. The notice requirements of section 101(m) of ERISA are effective with respect to plan years beginning after December 31, 2006.

### III. TRANSITIONAL GUIDANCE

This Part III provides transitional guidance with respect to § 401(a)(35). The transitional guidance provided in this Part III applies pending the issuance of further guidance.

#### A. Scope of Application.

Section 401(a)(35) imposes diversification requirements for defined contribution plans that hold publicly traded employer securities. Section 401(a)(35)(G)(iv) provides that the term employer security has the meaning given such term by section 407(d)(1) of ERISA. Under § 401(a)(35)(G)(v), the term publicly traded employer

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<sup>1</sup> Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed in this notice for purposes of section 204(j) of ERISA. Thus, the transitional guidance provided in this notice with respect to § 401(a)(35) also applies for purposes of section 204(j) of ERISA.

securities means employer securities which are readily tradable on an established securities market. For this purpose, if a plan holds employer securities that are not publicly traded, then, except as provided in Treasury regulations, those employer securities are nevertheless treated as publicly traded employer securities if any employer corporation, or any member of the controlled group of corporations that includes an employer corporation, has issued a class of stock that is a publicly traded employer security. For this purpose, an employer corporation means any corporation that is an employer maintaining the plan and a controlled group of corporations has the meaning given under § 1563(a), except that 50% is substituted for 80% wherever it occurs in § 1563.<sup>2</sup>

However, under this notice, a plan (and an investment option described in the last paragraph of Part IIIC of this notice) is not treated as holding employer securities to which § 401(a)(35) applies with respect to any securities held by either an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle that is regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in the securities is made both in accordance with the stated investment objectives of the investment vehicle and independent of the employer and any affiliate thereof, but only if the holdings of the investment company or similar investment vehicle are diversified so as to minimize the risk of large losses.

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<sup>2</sup> See §401(a)(35)(F)(ii) for an exception that applies to certain controlled groups with publicly traded securities.

In addition, § 401(a)(35) does not apply to an employee stock ownership plan (ESOP) if (1) there are no contributions held in the plan (or earnings thereunder) which are elective deferrals, employee after-tax contributions, or matching contributions that are subject to § 401(k) or (m) and (2) the plan is, for purposes of § 414(l) and §1.414(l)-1 of the Income Tax Regulations, a separate plan from any other plan maintained by the employer. Thus, an ESOP is subject to § 401(a)(35) if either the ESOP holds any contributions to which § 401(k) or (m) applies (or earnings thereon) or the ESOP is a portion of a plan that holds any amounts that are not part of the ESOP.

**B. Applicable Individuals Who Have Diversification Rights.**

Section 401(a)(35) provides applicable individuals with diversification rights with respect to publicly traded employer securities held in the plan under subparagraphs (B) and (C) of § 401(a)(35). The diversification rights under subparagraph (B) of § 401(a)(35) apply with respect to elective deferrals and employee contributions (and earnings thereon) and are required to be available to (1) any participant, (2) any alternate payee who has an account under the plan, and (3) any beneficiary of a deceased participant. For this purpose, employee contributions include both employee after-tax contributions and rollover contributions held under the plan. The diversification rights under subparagraph (C) of § 401(a)(35) apply with respect to other employer contributions (and earnings thereon) and are required to be available to each applicable individual who is either (1) a participant who has completed at least three years of service, (2) an alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service, or (3) a

beneficiary of a deceased participant. For purposes of this notice, persons who are entitled to receive diversification rights are termed “applicable individuals.”

For purposes of § 401(a)(35)(C) and § 401(a)(35)(H) (the transitional rule described in paragraph E of this Part III), the date on which a participant completes three years of service occurs immediately after the end of the third vesting computation period provided for under the plan that constitutes the completion of a third year of service under § 411(a)(5). However, for a plan that uses the elapsed time method of crediting service for vesting purposes (or a plan that provides for immediate vesting without using a vesting computation period or the elapsed time method of determining vesting), the date on which a participant completes three years of service is the third anniversary of the participant’s date of hire.

C. Basic Divestiture Rules.

An applicable individual is required to be permitted to elect to direct the plan to divest any publicly traded employer securities held in his or her account under the plan and to reinvest an equivalent amount in other investment options offered under the plan with respect to the portion of the account that is subject to subparagraph (B) or (C) of § 401(a)(35) to the extent applicable. This diversification right only applies when publicly traded employer securities are held under the plan and allocated to the participant’s or beneficiary’s account.

Under § 401(a)(35)(D)(i), the investment options offered must include not less than three investment options, other than employer securities, to which the applicable individual may direct the proceeds of the divestment of employer securities, and each

investment option must be diversified and have materially different risk and return characteristics. For this purpose, investment options that satisfy the requirements of § 2550.404c-1(b)(3) of the Department of Labor Regulations are treated as being diversified and having materially different risk and return characteristics.

D. Restrictions or Conditions on Divestiture Rights.

1. Conditions or Restrictions. Under § 401(a)(35)(D)(ii)(I), a plan is not treated as failing to meet the requirements of § 401(a)(35) merely because the plan limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly. Section 401(a)(35)(D)(ii)(II) prohibits a plan from imposing restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. For purposes of this prohibition in § 401(a)(35)(D)(ii)(II), except as described below in this Part IIID, a restriction or condition with respect to employer securities includes: (1) a restriction on an applicable individual's rights to divest an investment in employer securities that is not imposed on an investment that is not in employer securities; and (2) a benefit that is conditioned on investment in employer securities. Thus, the following are examples of prohibited restrictions or conditions:

- A plan allows applicable individuals the right to divest employer securities on a periodic basis (such as quarterly), but permits divestiture of another investment on a more frequent basis (such as daily). However, see paragraph 4 of this Part IIID for a transitional rule.

- A plan under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of matching contributions) than a participant whose account remains invested in employer securities.

Similarly, the following are examples of restrictions or conditions that are not prohibited by § 401(a)(35)(D)(ii)(II), provided that the limitations apply without regard to a prior exercise of rights to divest employer securities:

- A provision that limits the extent to which an individual's account balance can be invested in employer securities. Thus, a provision that does not allow more than 10% of an individual's account balance to be invested in employer securities is permitted.
- A provision under which an employer securities investment fund is closed, i.e., other amounts invested under the plan cannot be transferred into an investment in a class of employer securities (and no contributions are permitted to be invested in that class of employer securities).

However, a provision under which, if a participant divests his or her account balance with respect to investment in a class of employer securities, the participant is not permitted for a period of time thereafter to reinvest in that class of employer securities is a restriction that is prohibited by § 401(a)(35)(D)(ii)(II), because this limitation takes into account a prior exercise of rights to divest employer securities.

2. Permitted Restrictions. A restriction imposed by reason of the application of securities laws or a restriction that is reasonably designed to ensure compliance with such laws is not an impermissible restriction or condition under § 401(a)(35)(D)(ii)(II). Thus, for example, for purposes of ensuring compliance with Rule 10b-5 of the Securities and Exchange Commission, a plan may limit divestiture rights for participants who are subject to Section 16(b) of the Securities Exchange Act of 1934 to a period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements. In addition, an impermissible restriction or condition under § 401(a)(35)(D)(ii)(II) does not include the imposition of fees on other investment options under the plan merely because fees are not imposed with respect to investments in employer securities. Further, a plan may restrict the application of otherwise applicable diversification rights under the plan for up to 90 days following an initial public offering of the employer's stock.

3. Transition Rule Through March 30, 2007 for Continuation of Existing Restrictions or Conditions. For the period from January 1, 2007, through March 30, 2007, a plan does not impose a restriction or condition prohibited by § 401(a)(35)(D)(ii)(II) merely because the plan restricts diversification rights with respect to employer securities pursuant to a plan provision that was in effect on December 18, 2006. However, any such restriction that continues to be imposed on or after March 31, 2007, violates § 401(a)(35)(D)(ii)(II).

4. Transition Rule for 2007 for Grandfathered Investments. For the period prior to January 1, 2008, a plan does not impose a restriction or condition prohibited by



§ 401(a)(35)(D)(ii)(II) merely because the plan, as in effect on December 18, 2006, (1) does not impose an otherwise applicable restriction on a stable value fund or (2) allows applicable individuals the right to divest employer securities on a periodic basis, but permits divestiture of another investment on a more frequent basis, provided that the other investment is not a generally available investment (e.g., the other investment is only available to a fixed class of participants). However, any such restriction that continues to be imposed after December 31, 2007, violates § 401(a)(35)(D)(ii)(II).

E. Transition Rule under § 401(a)(35)(H).

Section 401(a)(35)(H) provides a special transition rule under which, for employer securities acquired in a plan year beginning before January 1, 2007, the diversification rights under subparagraph (C) of §401(a)(35) only apply to the applicable percentage of the number of shares of those securities. The applicable percentage is 33% for the first plan year to which § 401(a)(35) applies, 66% for the second plan year, and 100% for all subsequent plan years. If a plan holds more than one class of securities, § 401(a)(35)(H) applies separately with respect to each class. This transition rule does not apply to a participant who, before the first plan year beginning after December 31, 2005, had attained age 55 and completed at least three years of service.

F. Notice under Section 101(m) of ERISA.

In addition to amending the Code and ERISA to provide applicable individuals with the divestiture rights discussed in this notice, PPA '06 also added section 101(m) to ERISA, which requires plans to notify applicable individuals of these rights.

Specifically, plan administrators must provide a notice to applicable individuals not later than 30 days before the first date on which the individuals are eligible to exercise their rights. The notice must set forth the diversification rights provided under § 401(a)(35) and describe the importance of diversifying the investment of retirement account assets. Section 101(m) of ERISA is effective for plan years beginning after December 31, 2006.

Although some plans will be required to comply with § 401(a)(35) as early as January 1, 2007, the Department of Labor has advised Treasury and the Service that section 101(m) of ERISA does not require plans to furnish notices before January 1, 2007. Pursuant to this interpretation, plans with plan years beginning on or after January 1, 2007, but before February 1, 2007, are not required to furnish the model notice included herein (or a notice otherwise meeting the requirements of section 101(m) of ERISA) earlier than January 1, 2007. The Department, however, encourages plans to furnish notice on the earliest possible date.

#### G. Model Notice.

Section 507(c) of PPA '06 directs the Secretary of the Treasury to prescribe a model notice for purposes of section 101(m) of ERISA<sup>3</sup>. The model below is being issued pursuant to that directive.

The model may have to be adapted to reflect particular plan provisions. For example, changes would generally be necessary if either the plan has more than one

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<sup>3</sup> Section 101(m) of ERISA is under the jurisdiction of the Department of Labor.

class of employer securities, the plan provides the same diversification rights for participants without regard to whether they have three years of service, some of the plan's investment options are closed, the plan receives participant elections electronically, or the transition rule at § 401(a)(35)(H) is being applied.

### **Notice of Your Rights Concerning Employer Securities**

This notice informs you of an important change in Federal law that provides specific rights concerning investments in employer securities (company stock). Because you may now or in the future have investments in company stock under the [*insert name of plan*], you should take the time to read this notice carefully.

#### **Your Rights Concerning Employer Securities**

For plan years beginning after December 31, 2006, the Plan must allow you to elect to move any portion of your account that is invested in company stock from that investment into other investment alternatives under the Plan. This right extends to all of the company stock held under the Plan, except that it does not apply to your account balance attributable to [*identify any accounts to which the rights apply only after three years of service*] until you have three years of service. [*Insert description of any advance notice requirement before a diversification election becomes effective.*] You may contact the person identified below for specific information regarding this new right, including how to make this election. In deciding whether to exercise this right, you will want to give careful consideration to the information below that describes the importance of diversification. All of the investment options under the Plan are available to you if you decide to diversify out of company stock.

#### **The Importance of Diversifying Your Retirement Savings**

To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security, to perform poorly. If you invest more than 20% of your retirement savings in

any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.

In deciding how to invest your retirement savings, you should take into account all of your assets, including any retirement savings outside of the Plan. No single approach is right for everyone because, among other factors, individuals have different financial goals, different time horizons for meeting their goals, and different tolerances for risk. Therefore, you should carefully consider the rights described in this notice and how these rights affect the amount of money that you invest in company stock through the Plan.

It is also important to periodically review your investment portfolio, your investment objectives, and the investment options under the Plan to help ensure that your retirement savings will meet your retirement goals.

#### **For More Information**

If you have any questions about your rights under this new law, including how to make this election, contact [*enter name and contact information*].

#### **IV. REGULATIONS**

The Service and Treasury plan to issue regulations under § 401(a)(35) and those regulations will be consistent with the transitional guidance issued in this notice.

#### **V. COMMENTS REQUESTED**

Comments are requested on § 401(a)(35), including the issues raised in Part III of this notice and issues that should be addressed in regulations. Any comments received on the notice rules, including the model notice above, will be provided to the Department of Labor.

Written comments should be submitted by March 18, 2007. Send submissions to CC:PA:LPD:DRU (Notice 2006-107), Room 5203, Internal Revenue Service, POB

7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered to CC:PA:LPD:DRU (Notice 2006-107), Room 5203, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, comments may be submitted via the Internet at [notice.comments@irs.counsel.treas.gov](mailto:notice.comments@irs.counsel.treas.gov) (Notice 2006-107). All comments will be available for public inspection.

#### VI. Paperwork Reduction Act

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-2049. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is in the model notice provision of IIF. This information is required under section 507 of PPA'06. This information will be used to allow individual plans to comply with applicable law. The likely respondents are businesses or other for-profit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 7,725 hours.

The estimated annual burden per respondent and/or recordkeeper varies from 1 minute to 3 hours, depending on individual circumstances, with an estimated average of  $\frac{3}{4}$ 's of an hour. The estimated number of respondents and/or recordkeepers is 10,300.

The estimated frequency of responses is occasional.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

#### DRAFTING INFORMATION

The principal drafter of this notice is Robert Gertner of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at (877) 829-5500 (a toll-free number) between the hours of 8:30 a.m. and 4:30 p.m. Eastern Time, Monday through Friday. Mr. Gertner may be reached at (202) 283-9888 (not toll-free number).