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Diversification Requirements for Defined Contribution Plans

The IRS has issued proposed regulations relating to the diversification requirements for certain defined contribution plans that use publicly traded employer securities. The proposed regulations are effective for plan years beginning on or after January 1, 2009.

Under the Pension Protection Act of 2006, individuals have the right to divest employer securities in their accounts and reinvest the amounts in certain diversified investments. The diversification requirements are generally effective for plan years beginning after December 31, 2006. Transition guidance, released November 30, 2006, fleshed out and provided details for meeting the diversification requirements. The IRS subsequently extended the transition guidance and relief to plan years beginning on or after January 1, 2009. The proposed regulations follow transition guidance in large part. However, significant changes to the transition guidance include the following items.

Pooled Investment Vehicles. Employer securities held by an investment company registered under the Investment Company Act of 1940 or similar pooled investment vehicle are not treated as being held by the plan. Proposed regulations clarify that the following types of pooled investment vehicles are exempt from the diversification requirements: a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a state or federal agency, a pooled investment fund of an insurance company qualified to do business in a state, or an investment fund designated by the IRS.

Restriction of Diversification Rights. Transition guidance permitted a plan to restrict the otherwise applicable diversification rights for a period of up to 90 days following an initial public offering of the employer's stock. Under the proposed regulations, this rule is extended to apply to the first 90 days after the plan becomes an applicable defined contribution plan. This situation could occur, for example, when some other entity in the controlled group first issues stock that is publicly traded or when a standalone ESOP first provides for contributions that are subject to Code Sec. 401(k) or 401(m).

Restrictions on Employer Securities. Transition guidance allows a plan to impose a restriction on an investment in employer securities that is not imposed on a stable value fund. Proposed regulations extend this rule to a fund that is similar to a stable value fund. Specifically, in the case of a plan that has several investment funds, including a fund invested in employer securities, a fund that is a stable value or similar fund, and other funds that are not invested in employer securities, the plan does not impose a prohibited restriction merely because the plan permits transfers to be made into the stable value or similar fund more frequently than in the fund invested in employer securities.

Restrictions on Elections. The proposed regulations would allow a restriction on the frequency of investment elections that was not in transition guidance. Under proposed regulations, a plan is permitted to impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities, provided the restrictions are designed to limit short-term trading in the employer securities. For example, a fund could limit the purchase of employer securities if there has been a sale within a short period of time, such as seven days. The regulations, however, would not permit a plan to limit an individual's right to divest employer securities.

The diversification requirements for defined contribution plans are complex. Please call us at your earliest opportunity to discuss how the proposed regulations affect your plan. We will be happy to answer your questions. 1-866-657-0246 or jwaage@strategiclawgrouppc.com