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### **Investments**

#### **IRS Issues Final Rule on Diversification Of Defined Contribution Plan Investments**

The Treasury Department and Internal Revenue Service released a final rule (T.D. 9484) May 18 clarifying several exceptions to investment diversification requirements under tax code Section 401(a)(35) that apply generally to defined contribution plans holding publicly traded employer securities.

Defined contribution plan trusts can be disqualified under the final regulation unless those trusts satisfy the diversification requirements for elective deferrals and employee contributions, employer nonelective contributions, and investment options. Section 401(a)(35) was added by the Pension Protection Act of 2006 (Pub. L. No. 109-280).

Under the regulation, a defined contribution plan that holds publicly traded employer securities, referred to in the regulation as "an applicable defined contribution plan," is subject to the diversification requirements of Section 401(a)(35), unless it is exempt under Section 401(a)(35)(E) as a standalone employee stock ownership plan or a one-participant retirement plan.

The proposed and final rule provided limited exemptions from the diversification requirements for collective trust funds or pooled investment funds maintained by banks or trust companies supervised by a state or federal agency, pooled investment funds of insurance companies qualified to do business in a state, and investment funds designated by IRS in published guidance.

The rule is scheduled for publication in the May 19 *Federal Register*.

#### **Effect on Multiemployer Plans**

"The final regulation makes it clear that a multiemployer plan is not subject to the diversification rule merely because the investment manager decides to invest in the stock of one of the contributing employers," Louis Mazawey, a principal at Groom Law Group in Washington, D.C., told BNA May 18.

The final package of rules is not significantly different from the proposed rules, but it is more workable in important areas, Mazawey said. For example, the final regulation provided "a pretty reasonable transition rule" for ESOPs that make matching contributions in employer stock, he said. IRS provided transitional relief for leveraged ESOPs that cannot stop allocations of employer securities without a significant effect on the ESOP companies' debt arrangements.

#### **Effective Date**

The final regulation under tax code Section 401(a)(35) is effective and applicable to plan years beginning on or after Jan. 1, 2011. During the interim period, plans may rely on Notice 2006-107, the proposed regulation, or the final regulation, IRS said.

IRS issued a proposed regulation (REG-136701-07) in January 2008 (1 PBD, 1/3/08; 35 BPR 69, 1/8/08). The proposed regulation incorporated earlier guidance on diversification rights published in Notice 2006-107 (229 PBD, 12/1/06; 33 BPR 2809, 12/5/06).

#### **Response to Comments**

IRS responded in the final rule to comments requesting broader exemptions from the proposed diversification requirements by allowing an exemption for multiemployer plans, provided that employer securities are held indirectly through an investment fund managed by an investment manager, the investment is independent of the employer, and a percentage limitation rule is satisfied.

Some commenters had requested that the proposed percentage limitation rule be eliminated, suggesting that it would be too costly to monitor an investment fund to prevent the aggregate value of employer securities from exceeding 10 percent of the total assets in a defined contribution plan investment fund. IRS responded in the final rule by providing that plan administrators could make that percentage determination based on disclosure of a fund's portfolio holdings filed with the Securities and Exchange Commission in the preceding plan year.

The final regulation also provided clarification sought by the Profit Sharing/401k Council of America that a plan can permit reinvestment of dividends from employer stock into a frozen fund if the frozen fund is the plan's only employer stock fund.

Responding to comments from the U.S. Chamber of Commerce, IRS included language in the final regulation that permits plans to allow more frequent transfers in and out of stable value funds than are permitted in and out of employer stock funds.

The final regulations also provided that defined contribution plans may impose reasonable restrictions to limit short-term trading in employer securities.

*By Florence Olsen*

*Text of the final rule is in the Text section.*

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