

Part III - Administrative, Procedural, and Miscellaneous

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

Notice 2006-xx

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 proposed regulations under §_401(a)(35) and requests comments on the transitional guidance in this notice and on the proposed regulations.

II. BACKGROUND

Section 401(a)(35), as added by section 901 of PPA '06, provides that, to remain qualified under §_401(a) of the Code, 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 [of PPA '06](#) also added a parallel provision, section 204(j), to the Employee Retirement Income Security Act of 1974 (ERISA).¹ 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. Sections 901 and 507 of PPA '06 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.

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

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) of the Code, the term publicly traded employer securities means employer securities which are readily tradable on an established securities market. In a plan holding employer securities that are not publicly traded, those employer securities are nevertheless treated as publicly traded employer securities for purposes of § 401(a)(35) and this notice if any employer corporation, or a 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 §1563.²

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

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

Draft 11-10-06 11 am

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.

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), which applies with respect to elective deferrals and employee after-tax contributions (and earnings thereon), and to other employer contributions (and earnings thereon). The diversification rights under subparagraph (B) of §_401(a)(35) apply with respect to elective deferrals and employee after-tax contributions (and earnings thereon) and are required to be available to any participant and any beneficiary (including, for this purpose, any alternate payee). .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 completed at least three years of service, or (3) a beneficiary of a deceased participant. For purpose of this notice persons who are entitled 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. This diversification right only applies when publicly traded employer securities

Draft 11-10-06 11 am

are held under the plan and allocated to the participant's or beneficiary's account.

Under §_401(a)(35)(D)(ii)(I), a plan is not treated as failing to meet this requirement merely because the plan limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

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.

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 paragraph (D), a restriction or condition with respect to employer securities includes: (1) a restriction on investment control applicable under the plan to 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).
- 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.
- A plan provides that if a participant divests his or her account balance with respect to investments in a class of employer securities, the participant is not permitted to reinvest in that class of employer securities for a period of time (but such a provision is not impermissible if all participants' future contributions are not permitted to be invested in that class of employer securities).

However, pending future guidance, an impermissible restriction or condition does not include a restriction imposed by reason of the application of securities laws or a restriction that is reasonably designed to ensure compliance with such laws. 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 and Exchange Act of 1934 to a period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements.

Draft 11-10-06 11 am

In addition, an impermissible restriction or condition does not include the imposition of fees with respect to other investment options under the plan merely because fees are not imposed with respect to investments in employer securities. Further, pending future guidance, a plan may restrict the application of otherwise applicable diversification rights for up to 90 days following an initial public offering of the employer's stock under the plan.

In addition, 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 **[INSERT DATE OF PUBLICATION]**. However, any such restriction that continues to be imposed on or after March 31, 2007 violates § 401(a)(35).

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 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. Model Notice.

Pursuant to section 507(c) of PPA '06, there are two models below, which are designed to include content that satisfies the notice requirements of section 101(m) of ERISA. The first model is available in all cases, The second model is to be sent shortly before a participant becomes entitled to diversification rights and is designed only for cases in which the plan's summary plan description (SPD) includes the information that is in the first model (i.e., describes both rights of participants to divest employer securities, including the alternative investments available, and the importance of diversifying plan investments), so that the notice provided to a participant under the second model functions as a reminder of information that has previously been provided to the participant in the SPD.

The models may have to be adapted to reflect particular plan provisions. For example, changes would generally be necessary in the first model if either the plan has more than one class of employer securities, the plan provides the same diversification rights for participants without regard to whether they have three years of service, the plan receives participant elections electronically, or the transition rule at § 401(a)(35)(H) [of the Code](#) is being applied.

1. First Model – Available for Use in All Cases.

**Notice of Your Rights Concerning
Employer Securities**

On August 17, 2006, a new Federal law was enacted, entitled the Pension Protection Act of 2006 (Public Law 109-280). This notice is intended to inform you of a provision of the law that provides you with specific rights concerning your investment in employer securities (company stock) under the *[enter name of plan]*. You should take the time to read this notice carefully.

Your Rights Concerning Employer Securities

Under the new law, which applies to plan years beginning after December 31, 2006, the Plan must allow you to divest holdings in company stock and reinvest that amount in other investment alternatives under the Plan. The Plan must inform you at least 30 days in advance of this right. We are sending you this notice because we have determined that as of *[enter applicable date]* you have the right to divest some or all of the money in your individual account invested in company stock. *[If the participant already has diversification rights that satisfy section 204(j) of ERISA, substitute the following for the preceding sentence: We are sending you this notice to remind you of this right and the importance of diversification.]* 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 available under the Plan, which are described in the Plan's summary plan description, are available to you if you decide to diversify out of company stock, including, as required by the new law, at least three different alternative investment options (other than company stock), each of which is diversified and has materially different risk and return characteristics.

The Importance of Diversifying Your Retirement Savings

To help you achieve long-term retirement security, you should give careful consideration to the benefits of a balanced and diversified investment portfolio. It is generally accepted that spreading your assets among different types of investments will help you achieve a favorable rate of return, while minimizing your overall risk of losing money. Although diversification does not guarantee against loss, it is a very effective strategy to help you manage the risk of large losses.

In order to diversify your retirement savings, you should think about diversifying in two ways – both between different categories of investments (for example, investing in stocks, bonds, cash equivalents, and possibly other alternatives) and also within each category (for example, investing in the stocks and bonds of different companies and in different industries). 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 or on average. As a result, if you invest in a variety of assets, you may be able to offset some of your losses with gains in other categories and, over time, enjoy more stable returns.

How you choose to allocate your retirement savings is a very personal choice and should take into account all of your assets, including any retirement savings outside of the Plan. There is no single approach that 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.

However, you should be aware of the risk that your retirement savings may not be adequately diversified if you hold a substantial portion of your savings, for example more than 20%, in any one investment, including company stock, or in any one industry. 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.

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*].

2. Second Model -- Available for Use Only If Diversification Rights are Described in the SPD.

Notice of Your Rights Concerning Employer Securities

On August 17, 2006, a new Federal law was enacted, entitled the Pension Protection Act of 2006 (Public Law 109-280). This notice is intended to inform you of a provision of the law that provides you with specific rights concerning your investment in employer securities (company stock) through the [*enter name of Plan*].

Your Rights Concerning Employer Securities and the Importance of Diversifying

Your Retirement Savings

Under the new law, which applies to plan years beginning after December 31, 2006, the Plan must allow you to divest holdings in company stock and reinvest that amount in other investment alternatives under the plan. The Plan must inform you at least 30 days in advance of this right. We are sending you this notice because we have determined that as of [enter applicable date] you have the right to divest some or all of the money in your individual account invested in company stock. [If the participant already has diversification rights that satisfy section 204(j) of ERISA, substitute the following for the preceding sentence: We are sending you this notice to remind you of this right and the importance of diversification] This right is described on [enter page or section number] of the Summary Plan Description you have received. That description also includes an explanation of the general importance of diversifying your investments under the Plan as an effective strategy to help you manage the risk of large losses. You should take the time to read that information carefully.

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. PROPOSED REGULATIONS

It is expected that proposed regulations will be issued under § 401(a)(35) and that 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 proposed regulations. Any comments received on the notice rules, including model notices above, will be provided to the Department of Labor.

Written comments should be submitted by [INSERT DATE [90 days from date of publication2007](#)]. Send submissions to CC:PA:LPD:DRU (Notice 2006-xx), Room

Draft 11-10-06 11 am

5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C.

20044. Comments may be hand delivered between the hours of 8:30 a.m. and 4:30 p.m., Monday through Friday, to Courier's Desk, Room 105, First Floor, Internal Revenue Service, Attn: CC:PA:LPD:DRU (Notice 2006-xx), Crystal Mall 4 Building at 1901 S. Bell St. in Arlington, VA. Alternatively, comments may be submitted via the Internet at notice.comments@irscounsel.treas.gov (Notice 2006-xx). 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-_____ . 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 III.F. This information is required to enable the Office of the Director, Employee Plans, Tax Exempt and Government Entities Division of the Internal Revenue Service to monitor an employer's compliance with the qualification requirements of § 401(a)(35) of the Code. This information will be used to allow individual plans to continue to maintain their tax qualified and tax-deferred status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are businesses or other for-profit institutions, institutions, and small businesses or

organizations .

The estimated total annual reporting and/or recordkeeping burden is 313,500 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 minute to 3 hours, depending on individual circumstances, with an estimated average of $\frac{3}{4}$ hours. The estimated number of respondents and/or recordkeepers is 418,000 .

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 1-877-829-5500 (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).