F. Notice of Freedom to Divest Employer Securities (new sec. 101(m) of ERISA)

Present Law

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan. This information includes, for example, a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan. Under ERISA, if a plan administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

Explanation of Provision

The provision requires a new notice in connection with the right of an applicable individual to divest his or her account under an applicable defined contribution plan of employer securities, as required under the provision of the provision relating to diversification rights with respect to amounts invested in employer securities. Not later than 30 days before the first date on which an applicable individual is eligible to exercise such right with respect to any type of contribution, the administrator of the plan must provide the individual with a notice setting forth such right and describing the importance of diversifying the investment of retirement account assets. Under the diversification provision, an applicable individual's right to divest his or her account of employer securities attributable to elective deferrals and employee after-tax contributions and the right to divest his or her account of employer securities attributable to other contributions (i.e., nonelective employer contributions and employer matching contributions) may become exercisable at different times. Thus, to the extent the applicable individual is first eligible to exercise such rights at different times, separate notices are required.

The notice must be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the applicable individual. The Secretary of Treasury has regulatory authority over the required notice and is directed to prescribe a model notice to be used for this purpose within 180 days of the date of enactment of the provision. It is expected that the Secretary of Treasury will consult with the Secretary of Labor on the description of the importance of diversifying the investment of retirement account assets. In addition, it is intended that the Secretary of Treasury will prescribe rules to enable the notice to be provided at reduced administrative expense, such as allowing the notice to be provided with the summary plan description, with a reminder of these rights within a reasonable period before they become exercisable.

In the case of a failure to provide a required notice of diversification rights, the Secretary of Labor may assess a civil penalty against the plan administrator of up to

$100 a day from the date of the failure. For this purpose, each violation with respect to any single applicable individual is treated as a separate violation.

Effective Date

The provision generally applies to plan years beginning after December 31, 2006. Under a transition rule, if notice would otherwise be required to be provided before 90 days after the date of enactment, notice is not required until 90 days after the date of enactment.

TITLE IX: INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION

A. Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets (new sec. 401(a)(35) of the Code and new sec. 204(j) of ERISA)

Present Law

In general

Defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a "section 401(k) plan"), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions.

Under the Code, elective deferrals, after-tax employee contributions, and employer matching contributions are subject to special nondiscrimination tests. Certain employer nonelective contributions may be used to satisfy these special nondiscrimination tests. In addition, plans may satisfy the special nondiscrimination tests by meeting certain safe harbor contribution requirements.

The Code requires employee stock ownership plans ("ESOPs") to offer certain plan participants the right to diversify investments in employer securities. The Employee Retirement Income Security Act of 1974 ("ERISA") limits the amount of employer securities and employer real property that can be acquired or held by certain employer-sponsored retirement plans. The extent to which the ERISA limits apply depends on the type of plan and the type of contribution involved.

Diversification requirements applicable to ESOPs under the Code

An ESOP is a defined contribution plan that is designated as an ESOP and is

designed to invest primarily in qualifying employer securities and that meets certain other requirements under the Code. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be an entire plan or it can be a component of a larger defined contribution plan. An ESOP may provide for different types of contributions. For example, an ESOP may include a qualified cash or deferred arrangement that permits employees to make elective deferrals.[238]

Under the Code, ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.[239] The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[240]

ERISA limits on investments in employer securities and real property

ERISA imposes restrictions on the investment of retirement plan assets in employer securities or employer real property.[241] A retirement plan may hold only a "qualifying" employer security and only "qualifying" employer real property.

Under ERISA, any stock issued by the employer or an affiliate of the employer is a qualifying employer security.[242] Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). Qualifying employer real property means parcels of employer real property: (1) if a substantial number of the

parcels are dispersed geographically;

238 Such an ESOP design is sometimes referred to as a "KSOP."

239 Sec. 401(a)(28). The present-law diversification requirements do not apply to employer securities held by an ESOP that were acquired before January 1, 1987.

240 IRS Notice 88-56, 1988-1 C.B. 540, Q&A-16.

241 ERISA sec. 407.

242 Certain additional requirements apply to employer stock held by a defined benefit pension plan or a money purchase pension plan (other than certain plans in existence before the enactment of ERISA).

(2) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use; (3) even if all of the real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and (4) if the acquisition and retention of such property generally comply with the fiduciary rules of ERISA (with certain specified exceptions).

ERISA also prohibits defined benefit pension plans and money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities or employer real property if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities and real property. Except as discussed below with respect to elective deferrals, this 10-percent limitation generally does not apply to defined contribution plans other than money purchase pension plans.[243] In addition, a fiduciary generally is deemed not to violate the requirement that plan assets be diversified with respect to the acquisition or holding of employer securities or employer real property in a defined contribution plan.[244]

The 10-percent limitation on the acquisition of employer securities and real property applies separately to the portion of a plan consisting of elective deferrals (and earnings thereon) if any portion of an individual's elective deferrals (or earnings thereon) are required to be invested in employer securities or real property pursuant to plan terms or the direction of a person other than the participant. This restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer securities and real property does not exceed more than one percent of any employee's compensation; (2) the fair market value of all defined contribution plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP.

Explanation of Provision

In general

Under the provision, in order to satisfy the plan qualification requirements of the Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities. Such a plan is required to permit applicable individuals to direct that the portion of the individual's account held in employer securities be invested in alternative investments. An applicable individual includes: (1) any plan participant; and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

[243] The 10-percent limitation also applies to a defined contribution plan that is part of an arrangement under which benefits payable to a participant under a defined benefit pension plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

[244] Under ERISA, a defined contribution plan is generally referred to as an individual account plan. Plans that are not subject to the 10-percent limitation on the acquisition of employer securities and employer real property are referred to as "eligible individual account plans."

The time when the diversification requirements apply depends on the type of contributions invested in employer securities.

Plans subject to requirements

The diversification requirements generally apply to an "applicable defined contribution plan,"[245] which means a defined contribution plan holding publicly-traded employer securities (i.e., securities issued by the employer or a member of the employer's controlled group of corporations[246] that are readily tradable on an established securities market).

For this purpose, a plan holding employer securities that are not publicly traded is generally treated as holding publicly–traded employer securities if the employer (or any member of the employer's controlled group of corporations) has issued a class of stock that is a publicly-traded employer security. This treatment does not apply if neither the employer nor any parent corporation[247] of the employer has issued any publicly–traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to any member of the employer's controlled group that has issued any publicly–traded employer security. For example, a controlled group that generally consists of corporations that have not issued publicly-traded securities may include a member that has issued publicly–traded stock (the "publicly–traded member"). In the case of a plan maintained by an employer that is another

member of the controlled group, the diversification requirements do not apply to the plan, provided that neither the employer nor a parent corporation of the employer has issued any publicly–traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or issuer with respect to the member that has issued publicly– traded stock. The Secretary of the Treasury has the authority to provide other exceptions in regulations. For example, an exception may be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer's controlled group has issued a small amount of publicly-traded stock.

The diversification requirements do not apply to an ESOP that: (1) does not hold contributions (or earnings thereon) that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions; and (2) is a separate plan from any other qualified retirement plan of the employer. Accordingly, an ESOP that holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests (including the safe harbor methods of satisfying the tests) is subject to the diversification requirements under the Provision. The diversification rights applicable under the provision are broader than those applicable under the Code's present-law ESOP diversification rules. Thus, an ESOP that is subject to the new requirements is excepted from the present-law rules.[248]

The new diversification requirements also do not apply to a one–participant retirement plan. For purposes of the Code, a one–participant retirement plan is a plan that: (1) on the first day of the plan year, either covered only one individual (or the individual and his or her spouse) and the individual owned 100 percent of the plan sponsor (i.e., the employer maintaining the plan), whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; (2) meets the minimum coverage requirements without being combined with any other plan of the

245 Under ERISA, the diversification requirements apply to an "applicable individual account plan."

246 For this purpose, "controlled group of corporations" has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

247 For this purpose, "parent corporation" has the same meaning as under section 424(e), i.e., any corporation (other than the employer) in an unbroken chain of corporations ending with the employer if each corporation other than the employer owns stock possessing at least 50 percent of the total combined voting power of all classes of stock with voting rights or at least 50 percent of the total value of shares of all classes of stock in one of the other corporations in the chain.

business that covers employees of the business; (3) does not provide benefits to anyone except the individuals and partners (and spouses) described in (1); (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control; and (5) does not cover a business that uses the services of leased employees.[249] It is intended that, for this purpose, a "partner" includes an owner of a business that is treated as a partnership for tax purposes. In addition, it includes a two-percent shareholder of an S corporation.[250]

Elective deferrals and after–tax employee contributions

In the case of amounts attributable to elective deferrals under a qualified cash or deferred arrangement and employee after-tax contributions that are invested in employer securities, any applicable individual must be permitted to direct that such amounts be invested in alternative investments.

Other contributions

In the case of amounts attributable to contributions other than elective deferrals and aftertax employees contributions (i.e., nonelective employer contributions and employer matching contributions) that are invested in employer securities, an applicable individual who is a participant with three years of service,[251] a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in alternative investments.

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An ESOP will not be treated as failing to be designed to invest primarily in qualifying employer securities merely because the plan provides diversification rights as required under the provision or greater diversification rights than required under the provision.

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For purposes of ERISA, a one-participant retirement plan is defined as under the provision of ERISA that requires advance notice of a blackout period to be provided to participants and beneficiaries affected by the blackout period, as discussed below.

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Under section 1372, a two-percent shareholder of an S corporation is treated as a partner for fringe benefit purposes.

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Years of service is defined as under the rules relating to vesting (sec. 411(a)).

A transition rule applies to amounts attributable to these other contributions that are invested in employer securities acquired before the first plan year for which the new diversification requirements apply. Under the transition rule, for the first three years for which the new diversification requirements apply to the plan, the applicable percentage of such amounts is subject to diversification as shown in Table 1, below. The applicable percentage applies separately to each class of employer security in an applicable

individual's account. The transition rule does not apply to plan participants who have three years of service and who have attained age 55 by the beginning of the first plan year beginning after December 31, 2005.

Table 1.–Applicable Percentage for Employer Securities Held on Effective Date

Plan year for which diversification applies:	Applicable percentage:
First year	33 percent
Second year	66 percent
Third year	100 percent

The application of the transition rule is illustrated by the following example. Suppose that the account of a participant with at least three years of service held 120 shares of employer common stock contributed as matching contributions before the diversification requirements became effective. In the first year for which diversification applies, 33 percent (i.e., 40 shares) of that stock is subject to the diversification requirements. In the second year for which diversification applies, a total of 66 percent of 120 shares of stock (i.e., 79 shares, or an additional 39 shares) is subject to the diversification requirements. In the third year for which diversification applies, 100 percent of the stock, or all 120 shares, is subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee after-tax contributions is fully subject to the diversification requirements, as is any new stock contributed to the account.

Rules relating to the election of investment alternatives

A plan subject to the diversification requirements is required to give applicable individuals a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. It is intended that other investment options generally offered by the plan also must be available to applicable individuals.

A plan does not fail to meet the diversification requirements merely because the plan limits the times when divestment and reinvestment can be made to periodic, reasonable opportunities that occur at least quarterly. It is intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes, except in unusual circumstances. Thus, in general, applicable individuals must be given the opportunity to request changes with respect to investments in employer securities with the same frequency as the opportunity to make other investment changes and that such changes are implemented in the same timeframe as other investment

changes, unless circumstances require different treatment.

Except as provided in regulations, a plan may not impose restrictions or conditions with respect to the investment of 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). For example, such a restriction or condition includes a provision under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities. On the other hand, such a restriction 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.

Effective Date

The provision is effective for plan years beginning after December 31, 2006.

In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2007, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2008.

A special effective date applies with respect to employer matching and nonelective contributions (and earnings thereon) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum. Under the special rule, the diversification requirements apply to such preferred stock for plan years beginning after the earlier of (1) December 31, 2007; or (2) the first date as of which the actual value of the preferred stock equals or exceeds the guaranteed minimum. When the new diversification requirements become effective for the plan under the special rule, the applicable percentage of employer securities held on the effective date that is subject to diversification is determined without regard to the special rule.