Journal of Pension Benefits, The Dreaded Question: Can I Make Real Estate Investments in My Plan?, (Oct. 1, 2021)

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This article attempts to answer the "dreaded question" by exploring the complexities on the way to the answer.

Just the thought of that question chills most third-party administrators (TPAs) and even their lawyers to the bone. It seems so innocent. People usually ask it quizzically, even innocently. But be afraid! Be very afraid! It covers up a myriad of bubbling issues and concerns that can portend plan disaster.

Some consultants follow the Reagan-era advice: Just say no! This may be a recommendation made in response to a client's question as to the efficacy of real estate investing, or it may be a plea not to involve the advisor in the morass of real estate-related issues. Others, perhaps unaware of the concerns that apply to real estate in plans, may be carefree: Sure! The plan permits it! Why not?

But the real answer is more complex. This article attempts to provide it. The ultimate answer to the dreaded question, in any given situation may be as simple as yes or no. Getting there, however, is where all the complexity lies.

Usually, There Is No Outright Prohibition in a Plan Document Against Real Estate Investments

Most plans and the associated trusts are neutral regarding real estate. Property, as most investments, is usually permitted by the plan or, at least, not prohibited. So, if the question is whether the investment fiduciary *may* invest in real estate, the answer is almost always yes.

It is possible that the potential real estate investor is a novice. More often than not, though, when I'm asked the dreaded question, it comes from someone in the property biz. In fact, the asker is usually quite successful in his or her real estate investments—or thinks so at least. So, any warning one might want to make about making this investment from a prudence or a competence standpoint is likely to be shrugged off. "Forget it, girlie. I know what I'm doing."

Beware of the Prohibited Transaction

The most common concern, which comes to almost every professional's mind when the dreaded question is asked, is whether the proposed real estate investment is a personal or company investment in disguise. You want to buy a condo in Hawaii? On the beach? Who's going to stay in it? Buying commercial property? Who's going to rent it? Your company?

People and organizations closely related to the plan or the company sponsoring it cannot use plan investments for their own purposes. So, no one close to the plan or company can stay in the condo. No one can rent it. I don't care if you pay 10 times the reasonable rental value. I don't care if you offer it equally to your low-paid employees to use. For free. You can't do it. It's a prohibited transaction (PT). [IRC § 4975(c) ; ERISA § 406(a)]

For those who don't know, PTs are transactions between the plan and someone close to the plan, called a "party-in-interest" or a "disqualified person," depending on whether you are reading the Internal Revenue Code (Code) or the Employee Retirement Income Security Act of 1974 (ERISA). [IRC § 4975(e)(2) ; ERISA § 3(14)] Parties-in-interest include the plan sponsor; the owner(s), directors, and officers of the plan sponsor; plan fiduciaries; the participants and other employees; certain relatives of those individuals; other companies owned by the plan sponsor or the owners of the plan sponsor; unions covering employees of the plan sponsor; and service providers to the plan. There are several complex rules that treat these various parties as sometimes

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owning stock that is owned by another of these parties (the attribution rules). [IRC § 4975(e)(4)] It's a spider's web of relationships. If you have questions, talk to a lawyer. But, in general, these kinds of transactions are impermissible, hence the name prohibited transaction.

Even if the person using the property is not sufficiently related to the plan or the company for the transaction to be specifically prohibited, a relationship with the investment fiduciary can be enough. The law also contains so-called self-dealing PTs. Under these rules, broadly speaking, a fiduciary cannot use property of the plan for his or her own purposes. [IRC §§ 4975(c)(D), (E), and (F); ERISA § 406(b)] So, your next-door neighbor wants to use the condo for his family vacation. He's paying market rental value. But, if the Internal Revenue Service (IRS) or Department of Labor (DOL) thinks that your motive for that rental was your relationship with your neighbor, you can be guilty of self-dealing. And, if so, the rental to your neighbor is a PT.

Another PT can occur if the plan hires a related person or entity to provide services to the real estate. Consider the case of the client who is a real estate developer. He proposes buying real estate in the plan, and having the plan develop the property and sell it. Marvelous. Who is going to manage the development process, do the construction, get the permits, etc.? Oh, the plan sponsor? Not if he's intending to get paid, he's not. No can do. [IRC § 4975(c)(F) ; ERISA § 406(b)(3)] Remember again the self-dealing rules when you make this judgment. If you hire someone else for these tasks, but you get concessions in your normal real estate business because you gave the contract to someone with whom you commonly work, that's a PT, too.

In short: Everything has to be arm's length. If the plan sponsor is a real estate developer and the owner provides development services *for free* in his or her capacity as trustee of the plan, that may work. But that's as far as the involvement can go. (No, you can't charge for your own services. Which part of " *for free"* was unclear?)

One more thing. There is a "get out of jail free" card from PT rules for purchases of real estate that are used for company purposes—it's called employer real property. [ERISA § 408(e)] However, to take advantage of this, you need to have several pieces of property that are geographically dispersed. And, the DOL does not provide one free pass on that rule for the first piece of property that is purchased. So, unless the company is buying several parcels of property, these rules don't help.

Avoiding PTs by Putting the Real Estate Into a Company (and Having the Plan Invest in the Company)

"How about," my client asks, "if I start up an LLC and have the plan buy an interest in the LLC. Then, the LLC buys the property and I develop the property and such. All the plan owns is equity in the LLC, so I'm not doing business with the plan. Boom! Great idea, right?"

These real estate folks are very creative. So are Congress, the IRS, and the DOL.

There is this bizarre rule in ERISA that says (in short): If a plan invests in certain types of unincorporated entities, it is deemed to own anything the entity owns. [ERISA § 3(42) ; Labor Reg. § 2510.3-101(a)(2)]

What does that mean? Let's say that I own a share of IBM, which is a corporation. What I own is the share of stock. I do not own a small percentage of every asset owned by IBM. So, I can't go into an IBM office, sit in a chair, and say, "This is my chair. This is what my one share of IBM is invested in."

But, if a retirement plan owns equity in a partnership or an LLC that is taxed like a partnership, it is presumed to own a share of every asset the partnership or LLC owns. So, if the LLC has a contract with the plan sponsor, or if the plan sponsor uses any assets of the LLC, the plan is deemed to be in that relationship with the plan sponsor. Bingo. We're back in PT-land. (This attribution of equity ownership to the various partnership assets is generally referred to as the "look-through" rules.)

The look-through rules that determine when the plan is deemed to own the underlying assets of an entity in which it invests are wickedly complex. There are exceptions. But the key is: Someone who knows what they are doing must examine the proposed plan transaction to ensure that there is no inadvertent PT.

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Diversification and Liquidity

ERISA requires that the person responsible for investing plan assets must properly diversify the investments so as to avoid the risk of large losses. [ERISA § 404(a)(1)(C)] This may not be a concern if the plan at issue is sponsored by a company employing only the owner (or perhaps the owner and his or her spouse). However, if there are employees, it is very important.

Besides being properly diversified so that you do not put all of your employees' retirement funds at risk, the investment fiduciary must watch liquidity needs. If all the plan's assets are in real estate and someone leaves the company and asks for a distribution: How are you going to pay him/her?

Here's where the PT rules may help. If a plan is insufficiently liquid to pay expenses or benefits, an exemption from the PT rules permits the company to make an interest-free, unsecured loan to the plan to enable it to operate. The loan document must be in writing. [PTE 2000-14, Exemption Application D-10830 (4/30/2000)] Don't be too free with this kind of loan, however. It has the potential of evidencing improper diversification if used too much.

Sometimes, It Is Not Just the Appreciation That Makes Real Estate Investments Attractive

Investments outside the plan, whether real estate or otherwise, are taxed on their appreciation once the asset is sold. Under most circumstances, this is taxed as capital gains, at a lower rate than a taxpayer pays on ordinary income.

Investments made inside the plan are not taxed on appreciation—realized or unrealized. But, when a participant takes his or her benefit out of the plan, it is taxed as ordinary income.

So, imagine Joe Participant, a real estate guy, who has $100,000 in the plan and $100,000 outside the plan. He invests both pots of money in different, unrelated properties. In five years, he sells both parcels of property for $150,000. (Again, Joe knows his stuff.) Both Joe personally and the plan have experienced a gain of $50,000. The plan pays no tax. Joe pays capital gains tax at 20 percent ($10,000 of tax). He then takes his $40,000 balance and invests in the next real estate parcel.

The next day, Joe retires and takes the of proceeds from the plan as his retirement benefit. The entire distribution (including the $50,000 of gain he realized on the property) is taxed at ordinary income rates of 37 percent. The tax on the $50,000 gain is $18,500 – $8,500 more than would have been paid outside the plan.

OK, I know that is true about all investments that are made in the plan. Stocks, bonds, etc. would all be taxed at capital gains if made outside the plan. But there are other tax benefits from owning real estate, including deduction of certain expenses. The point is: Consider all of the ramifications of the investment being in the plan, as opposed to out of the plan, before you use plan assets.

Exit Strategy … Not Lookin' So Good

Stuff happens. What you plan for may not be what transpires. If the plan invests in real estate and it goes up in value, and there is a market for its purchase, and the plan sells it for a profit, everything is rosy.

However, our firm helps clients when things do not go as planned. So, consider instead the situation where the real estate goes down in value. And, then consider what happens if the plan needs to get rid of the property when the value is depressed.

Like when?

- The business owner needs money fast and wants to terminate the plan and take distribution of the assets. But the assets are illiquid. And there are rank-and-file employees. (More about that later.)
- Participants are terminating and we need to get the plan more liquid to pay them.

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- We are worried that the value of the property will decrease further, and we want to cut our losses by getting the asset out of the plan.
- We realize that the original purchase of the property involved a PT and the only way to fix it is to reverse the transaction … and we can't because there is no money to do it with.

The usual answer is some variation on: The owner will buy the property out of the plan. (Nope, that is a PT.) The owner will take a distribution of the property. (But what about the fact that part of it belongs to other participants, particularly if the owner's benefit is less than the total value of the property). The owner doesn't want the property, but his father-in-law does. (PT-land again).

The DOL has special provisions where an interested party can buy a piece of depreciated real estate out of the plan when there's no other available buyer, but it's not a slam dunk. [Voluntary Fiduciary Correction Program, 71 FR 20261 (4/19/2006), § 7.4(F)] It is possible, but it's not the lovely scenario that we originally envisioned when we bought this white elephant.

Assets Need to Be Valued Each Year at Fair Market Value

The Code and ERISA both require that the plan accounting be done at fair market value. [*See, e.g.,* Rev. Rul. 80-155] If the plan is a defined benefit plan, the value of the assets affects funding. If the plan is a 401(k) or other defined contribution plan, the value of the assets affects the participants' benefits. While neither the Code nor ERISA requires independent appraisals of most assets each year, it is hard to defend the value if it is under attack by the IRS (in regard to deductibility), a participant (in a lawsuit or claim for benefits), or the DOL (in an audit or representation on behalf of a participant) when there is no independent judgment being made. I know, I know. The plan sponsor is in the real estate biz and knows what property values should be. However, the plan sponsor's "my best belief off the top of my head" analysis is not likely to convince others who are skeptical. Better to get an appraisal or valuation each year, which adds to the cost.

Bonding and Form 5500 Reporting

And, last but not least, real estate investments are not "qualifying assets," which means that a plan with non-owner employees must file Form 5500 and get additional bonding or an independent CPA audit each year. [Labor Reg. § 2520.104-46] (The additional bond exempts the plan from the annual CPA audit, but not the requirement to file the Form 5500.)

The Form 5500 financial information will clearly disclose that the plan has invested in real estate—waiving a reasonably large red flag in the face of the IRS and DOL. [Form 5500, Schedule H, line 1c(6)(a) and (b)]

So, What's the Point?

The point is: Do not invest plan assets casually or thoughtlessly in real estate. It complicates administration, exposes the plan sponsor to additional requirements and risk of government scrutiny, can create prohibited transactions (leading to excise taxes, potential fiduciary breach, and more government scrutiny), and can raise qualification issues. It's not for the faint of heart.

Oh, one more thing: get legal counsel before you do this and listen to your lawyer. I know it goes against your maverick nature, but do it. You'll be sorry if you don't.

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