

Real Estate Investments by Pension Plans

By Bruce Ashton, Esq.

Can a pension plan invest in real estate? Simple question, and the answer is "sure." But is it a good idea? That's a harder question, and the answer isn't so simple. Because there can be a big difference between what's legal and what's a good idea, this article explores the top ten issues plan sponsors should consider before deciding to invest in real estate. (The issues addressed in this article relate principally to defined contribution plans; also, unless otherwise indicated, the concepts discussed relate to both participant-directed and trustee-directed plans.)

If exposure to real estate as an investment strategy is desirable, an alternative approach might be to purchase shares in a real estate investment trust (REIT), which, like a mutual fund, is a diversified investment that inherently spreads the risk of market downturns over a large number of properties. Thus, the first question might well be, why invest in a single, non-diversified asset unless there is some other agenda behind the purchase, such as the desire to use tax-favored dollars to invest in property to be used in the plan sponsor's business (which would generally be a prohibited transaction and might violate the exclusive benefit rule which requires that the plan be operated for the exclusive purpose of providing benefits to the participants). In other words, the individuals making the decision on behalf of the plan need to examine the issue very carefully.

Before getting into the specific questions, let's start with a preliminary issue — whether the plan is subject to Title I of ERISA, and more specifically, the fiduciary rules. Not all plans are subject to those rules because Title I of ERISA only applies to plans that provide benefits to "employees." Under DOL Regulations, a plan that covers only a business owner and his or her spouse is not considered to be a plan that covers employees and is thus exempt from Title I. See DOL Regulation Section 2510.3-3(b) and (c). For our purposes, however, we'll assume that the plan is a "Title I plan."

The Fiduciary Rules – Is It Prudent?

The plan fiduciaries need to decide whether investing in real estate will provide a competitive return so that the plan can satisfy the exclusive purpose rule. ERISA Section 404(a) requires fiduciaries to act in the best interest of the participants for the exclusive purpose of providing the promised benefits (in this case, retirement benefits). In so doing, the fiduciaries must act prudently. So the first question is whether the investment in real estate is prudent under ERISA.

This issue is less significant in a plan that complies with ERISA Section 404(c) and the related DOL Regulations, assuming the plan provides for individually directed accounts that permit participants to invest in any asset that it is "administratively feasible" for the plan to hold. The prudence issue largely goes away if the participants will have the right to decide what portion, if any, of their accounts are invested in the real estate (again, assuming compliance with 404(c)). But given the illiquid nature of real estate, a question would still exist as to whether holding real estate is "administratively feasible" — which means that making this option available to participants may make it more difficult to comply with 404(c).

What should a fiduciary consider in deciding whether the investment is prudent? Here are *some* of the questions the fiduciary might ask (though this is hardly an exhaustive list): Are there improvements (that is, buildings) on the property? Are they in good shape? Will the property be leased? What is the credit worthiness of the tenant(s)? Will the property be acquired with debt? Is the cash flow of the property sufficient to pay all carrying costs? Is the property in a high risk area, such as a fire or flood zone? What are the prospects for the plan to make money on the deal? Is the value of the property greater than or at least equal to the purchase price? (It would be a fiduciary breach to pay more than the fair market value for the property.)

The Fiduciary Rules – Diversification

Another requirement of the ERISA fiduciary rules is that the assets of the plan must be diversified. While there is no rule of thumb on how to satisfy this requirement, in the author's experience, the DOL generally takes the position that not more than 20-25 percent of the plan assets should be concentrated in any one investment or type of investment and will assert a fiduciary breach and demand correction if the concentration is higher. So if the real estate investment will require the plan

continued on page 13

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to invest more than this percentage in order to acquire the property — one plan we've dealt with invested 100 percent of the plan assets in real estate in a single district in one city and lost 100 percent of those assets — the plan may not satisfy this requirement, and the fiduciaries who authorize the transaction may be engaging in a fiduciary breach.

The Prohibited Transaction Rules – Purchases and Sales

A plan may not purchase property from nor sell property to a party-in-interest, which means a fiduciary of the plan, the plan sponsor, a 50 percent or more owner of the plan sponsor and certain others. So the plan cannot buy the property – or sell it later on – to an insider. If it does, the transaction has to be “corrected,” which means unwound, and the assets of the plan restored to what they would have been had the transaction never occurred. The fiduciaries who permit the transaction to occur are personally liable for any losses the plan suffers, including lost earnings (or even earnings at a level the plan could have received had it not engaged in the transaction), and could be required to pay a 20 percent penalty on top of any funds restored to the plan under ERISA Section 502(1) as well as excise taxes equal to 15 percent of the amount involved under Code section 4975. So, a property deal that looks like a great idea may not be such a great idea after all.

The Prohibited Transaction Rules – Use of the Property

Even if the original purchase is prudent, meets the diversification requirements and does not involve a prohibited transaction, the prohibited transaction rules could still come into play. This is because the property cannot be used by the plan sponsor or the business owner, cannot be leased to the plan sponsor or the business owner and cannot be sold at the end of the day to the plan sponsor or business owner. Furthermore, the plan cannot pay the plan sponsor or the business owner a fee for developing the property, managing the property or providing any other type of service related to the property. You can't use the tax-advantaged dollars of the plan to help the sponsor or owner make money outside the plan. If that's the objective, it won't work. (There is an exemption under ERISA Section 407(b)(1) for “qualifying employer real property,” which is property owned by the plan and leased to the employer; the exemption only applies if there are several parcels that are “dispersed geographically” and certain other requirements are met. In other words, the plan cannot lease a single parcel to the employer but can lease several different ones.)

Carrying Costs

The plan has to pay the carrying costs of the property, including items such as real property taxes, insurance, repairs, mortgage payments and the like. If the plan does not have sufficient cash to pay these items – either from rentals it will receive or other liquid investments held by the plan – the transaction is not a good idea. Plus, consider whether it is wise to tie up the plan's cash to pay property carrying costs. Further, if there is a mortgage on the property, as the debt is paid down, the net value of the asset will increase as a percentage of the plan's assets which could cause a diversification problem.

The UBIT Rules

The investment may be subject to the unrelated business income tax (UBIT) rules, which means that income derived from the investment is subject to tax even though it is inside a qualified plan. See Code sections 511-514. There are two situations where the UBIT rules come into play: where the plan is engaged in running a trade or business, and where the plan incurs debt to finance the purchase of the property. The rules here are very complicated – too complicated to discuss here in detail – and usually don't apply to real estate unless the real estate is incidental to the running of a business, such as a hotel or motel. However, the fiduciaries need to explore the possible application of these rules before making an investment to be sure because having to pay UBIT will significantly reduce the plan's return on the investment. This is especially true if the property is subject to a deed of trust or mortgage used to acquire the property. In addition, the plan sponsor or business owner cannot guarantee that debt (that would be another prohibited transaction). If the property is being developed for sale – e.g., a large parcel being developed and sold as lots or a property that is one in a series being developed and sold one right after another – the IRS might consider the property to be the “inventory” of a trade or business and apply the UBIT rules even where an exemption might otherwise appear to be available.

continued on page 17



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Valuation

The property needs to be valued each year, which can be difficult or possibly expensive. Except in rare circumstances, the plan should get a qualified appraisal of the property every few years (usually every 3) at the least. The IRS has taken the position in the past that a failure to properly value an asset in a defined contribution plan is a qualification failure. So the fiduciaries need to consider the expense and complication of having to determine the value of an inherently difficult-to-value asset.

Annual Reporting

If the property constitutes more than 5 percent of the value of the plan assets, the plan would need to have an annual audit by a CPA or purchase a bond equal to the value of the property under DOL Regulation Section 2520.104-46. An audit could materially increase the plan's costs (though obtaining a bond probably would not) and decrease its return on the real estate investment.

Income Taxes

Often one of the benefits of owning rental property is the ability to deduct carrying costs and depreciation against income from other sources. If the property is owned by a plan, the plan cannot take advantage of these deductions (except in the situation where the plan is subject to UBIT), so the deductions are

"lost." The fiduciaries should consider the trade-off between using pre-tax dollars to purchase and hold the property vs. the loss of the income tax deductions available to a taxable entity that owns the property. The trade-off may be worth it, but this is a consideration the fiduciaries need to assess.

Distributions

There are several issues here. Even if the investment is "prudent" from an ERISA perspective, is it wise? Meaning, is it worth the loss of the tax incentives of real estate ownership — e.g., deduction of interest on acquisition debt, depreciation and the like — to have the plan own it? And what happens to the asset when the business owner retires? Will the plan sell it? Is it worth converting capital gain income into ordinary income? That is, if the property is owned outside a plan, it would be a capital asset and any gain on the appreciation in value (assuming it does appreciate in value) when the property is sold is taxed at capital gains rates; whereas if the property is held by a plan, the participants will take distributions at ordinary income rates, regardless of whether the property is distributed in kind or is sold in the plan and the proceeds are distributed.

If the plan is going to distribute the property, there are several issues. Does the plan document specifically

permit distributions in kind? (It can certainly be amended to do so, but this is something easily overlooked.) Further, if the plan does so provide, the right to receive an in-kind distribution is a 411(d)(6) protected benefit, so that all participants have a right to receive an interest in the property. This, of course, is not particularly practical. If the plan distributes the property solely to the business owner in lieu of cash, this could cause plan disqualification on a number of grounds, including possible violation of the 401(a)(4) non-discrimination rules if the property is not valued properly.

Assuming you work around all of these issues, if the property is distributed, the owner must either pay tax on the value at ordinary income rates or must find an IRA custodian to which he can roll the property, which can be difficult and perhaps more expensive. And then the IRA needs to have the cash to continue to pay the carrying costs. These are all economic issues the fiduciaries need to consider at the front end, in addition to the legal issues discussed above, in deciding whether it is truly wise to invest in real estate.

So, there are lots of considerations. It may be a perfectly good investment for a plan — after all, many very large plans own lots of real estate. And in the right context, it can be a good investment for smaller plans, too. But owning real estate presents a number of practical complications that can lead to legal problems if the issues aren't carefully addressed — as well as some economic disadvantages that may make an investment in real estate less desirable than a client's initial enthusiasm suggests.*

Bruce Ashton is a shareholder of Reish Luftman Reicher & Cohen in Los Angeles, where he specializes in representing plan sponsors and fiduciaries in all aspects of employee benefits. Bruce served as the president of the American Society of Pension Professionals and Actuaries during 2003-2004 and is a frequent speaker at NIPA-sponsored events. Bruce would like to thank Fred Reish for his assistance in preparing this article. He can be reached at bruceashton@reish.com.

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