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Real Estate Investments in Qualified Plans

BY BROOKE K. COZORT

This article delves into the difficult answers as to whether or not Qualified Plans can invest in Real Estate.

Brooke Cozort, JD, CPC, is an ERISA Attorney at Harlowe & Falk LLP, located in Tacoma, WA, but works remotely out of Littleton, CO. She has over 20 years of experience working with qualified and nonqualified plan matters. Prior to starting her law career, Ms. Cozort was a partner and Vice President of Pension Services at Retirement Planning Services, Inc. (a TPA firm located in Denver, CO); her roles there included retirement plan design, ERISA consultant, and vendor and relationship management with recordkeepers, investment advisors, auditors, and actuaries.

In my work in the Employee Retirement Income Security Act (ERISA) field over the years, I have encountered the occasional plan where the trustees, many times doctors (…they tend to push the envelope, don't they?), ask the dreaded question: Can we invest plan assets in real estate? Perhaps a medical building…for diversification purposes? I always joke about what happens when a participant wants to take a distribution—do they get a window? A door?

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. This article attempts to answer the more complex part—the good, the bad, and the ugly.

Why Real Estate?

Trustees of qualified retirement plans invest in real estate for various reasons, some of which are allowed by ERISA and others which are not. It is generally permissible for a trustee to invest in real estate to improve the plan's rate of return and achieve greater diversification compared to more traditional investments, such as equities and bonds. Alternatively, a trustee may invest in real estate in order to finance certain business ventures or take advantage of a profitable investment for the benefit of himself or herself, which is not allowed. Regardless of the intent, the Internal Revenue

Service (IRS) or the Department of Labor (DOL) will scrutinize the facts and circumstances surrounding the investment to determine whether it is for the exclusive benefit of the participants and beneficiaries. If the investment is found to benefit any other person, the plan and fiduciary could face penalties. However, with thoughtful selection with an eye towards the plan participants, a trustee can utilize a real estate investment to enhance income productivity or principal appreciation, as might be desired for a particular trust portfolio.

May a Plan Invest in Real Estate?

The Internal Revenue Code (Code) regulates what investments are allowed in a qualified retirement plan but does not describe in what a retirement plan can invest, only in what it cannot invest. {IRC § 408(m)} Qualified retirement plans cannot invest in collectibles, such as art, antiques, gems, coins, or alcoholic beverages, but can invest in certain precious metals if certain requirements are met. {*Id.*} Therefore, a trustee must infer that other investments, aside from those enumerated above, are allowed in a qualified retirement plan so long as the trustee complies with all ERISA regulations relating to the investment.

In addition, the trustee must determine whether the plan and trust documents allow for the investment in real estate. More often than not, the plan document is silent on the topic. However, if real estate investments are specifically prohibited in the plan or trust document or in the investment policy statement, the plan sponsor should amend the documents prior to investing in real estate.

The Legal Side

Is Real Estate the Right Fit?—Fiduciary Duty

If the plan invests in real estate, a fiduciary must consider whether the investment is prudent, whether it allows the plan assets to be diversified, and whether it was previously owned by a party in interest.

ERISA defines a person as a fiduciary with respect to a plan to the extent that the person exercises any discretionary authority or control in the management of the plan or the disposition of its assets, renders investment advice for a fee, or has any discretionary authority or responsibility in the administration of the plan. {ERISA § 3(21)(A)} The operative portion of this rule in terms of real estate investments concerns the fiduciary's discretionary authority and management of plan assets. If a trustee invests plan assets in real estate, that trustee is a fiduciary and must adhere to the duties of a fiduciary with regard to that investment or risk breaching his or her fiduciary duty. ERISA provides for remedies for affected participants when such a breach occurs; however, that topic is beyond the scope of this article.

ERISA establishes four general rules to which fiduciaries must adhere when discharging their duties to a plan. In deciding whether and to what extent to invest in real estate, an ERISA fiduciary must comply with these rules.

1. Duty of Loyalty

A fiduciary must act solely in the interest of the plan participants and beneficiaries and for the exclusive purpose of providing them benefits and defraying reasonable administrative plan expenses. {ERISA § 404(a)(1)(A)} In the event of a DOL audit, the fiduciary should be prepared to provide the DOL with the details of a due diligent process for selection of the real estate investment and a clear indication that the investment is for the exclusive benefit of the participants and beneficiaries.

2. Duty of Care

A fiduciary must act with reasonable prudence. {ERISA § 404(a)(1)(B)} Under this provision, a fiduciary must give appropriate consideration to those facts and circumstances relevant to the investment, including the role the real estate investment plays in the plan's investment portfolio and act accordingly. {Labor Reg. § 2550.404a-1(b)} In my experience with a doctor plan investing in real estate, it is likely the doctor, who is the fiduciary, is not an expert in investing in real estate. Therefore, such a non-expert should seek the advice of an expert when investing in real estate. It is not enough, considering the duty of care, that a fiduciary simply invest in the real estate property in good faith reliance, as good faith will not excuse a lack of prudence.

3. Duty of Diversification

A fiduciary must diversify investments so as to minimize the risk of large losses, unless it is clearly prudent not to do so. {ERISA § 404(a)(1)(C)} This diversification requirement, however, does not limit the plan to a specific dollar amount or percentage for any one investment. Rather, the legislative history of ERISA states that ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property into one type of security, since the effect is to increase the risk of large losses. [*Id.*]

Although there is a duty to diversify, DOL guidance demonstrates a relative lack of appetite to find fiduciary violations in this area. In analyzing non-diversification claims, courts first determine whether plan investments are diverse and then determine whether non-diversified investments are nonetheless prudent under the circumstances. [DOL Advisory Op. F-4576 H, 1990] Therefore, although a plan may be invested heavily in real estate, it may be difficult for the DOL or a plan participant to successfully prove that the investment was not prudent if the fiduciary shows a prudent process and due diligence when the fiduciary made the decision.

4. Duty to Follow the Terms of the Plan Document

Finally, a fiduciary must act in accordance with the plan documents (including any investment policy statement or other investment guidelines) to the extent that to do so is consistent with the requirements of ERISA. [ERISA § 404(a)(1)(D)] When determining whether to invest in real estate, the fiduciary should review the plan's documents to ensure a real estate investment is allowed and review the investment policy statement to determine the process to be used for making such an investment decision.

In the event of a DOL audit, a fiduciary should be able to demonstrate that all the duties of the fiduciary have been considered and prudently followed in terms of investment selections for the plan. If any of the duties are not met, the DOL may determine that the fiduciary has breached his or her fiduciary duty.

How to Handle the Purchase of Real Estate—Prohibited Transactions

In addition to the fiduciary duties under ERISA, plan sponsors must also consider the prohibited transaction rules. The most common concern, which comes to mind when I receive the dreaded question is whether the proposed real estate investment is a personal or company investment in disguise. People and organizations closely related to the plan or the company sponsoring it cannot use plan investments for their own purposes.

In general, under the Code and ERISA, virtually all transactions between a qualified plan and a party in interest are prohibited unless an exemption is available. [ERISA § 406(a)] 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. [ERISA § 3(14); *see also*, IRC § 4975(e)(2), for a definition of "disqualified person," which is almost exactly identical to the party in interest definition in ERISA] In addition, there are several complex rules that treat these various parties as sometimes owning stock that is owned by another of these parties (the attribution rules). [IRC § 4975(e)(4)] It is a spider's web of relationships that should not be considered flippantly.

The following actions, discussed below, that may occur in connection with investing in real estate in a qualified retirement plan may constitute a prohibited transaction unless an exemption is available.

Sale or Transfer of Property

A fiduciary shall not cause the plan to engage in a transaction if the transaction constitutes a direct or indirect sale or transfer of any property between the plan and a party in interest. [ERISA § 406(a)(1)(A)] Therefore, when investing in real estate, the plan shall not directly purchase a piece of property from the owner of the company that sponsors the plan. The plan must purchase a piece of property not previously owned by any party in interest. In addition, the property must be titled under the name of the retirement plan. A purchase in the owner's name, simply for ease of the transaction, and then a transfer by the owner to the plan could be considered a prohibited transaction, and why give the IRS or DOL any bait! Additionally, when the plan terminates, the owner of the company that sponsors the plan should not purchase the property to facilitate issuing distributions to the participants.

Furnishing of Services

A fiduciary shall not cause the plan to engage in a transaction if the transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest. [ERISA § 406(a)(1)(C)] In regard to real property in a qualified retirement plan, goods and services may range from day-to-day maintenance to major redevelopment of the property itself and providing labor, equipment, or materials for such maintenance. This prohibition applies to both the provision of services by the party in interest and the receipt of those services by the plan. Therefore, the owner may not hire one of its affiliates to perform the maintenance, nor should the owner provide the equipment or materials for such services, absent an exemption.

Transfer to or Use by Party in Interest

A fiduciary shall not cause the plan to engage in a transaction if the transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. {ERISA § 406(a)(1)(D)} This provision would indicate that a party in interest may not use the plan's property for any reason. For example, the owner of the company sponsoring the plan could not use the property for a vacation home, nor could the owner allow any relative or employee to use the property for personal living quarters or for rental, regardless of the duration or amount of payment, even if offered at no cost.

Acquisition by the Plan of Employer Real Property

Finally, a fiduciary shall not cause the plan to engage in a transaction if the transaction constitutes a direct or indirect acquisition, on behalf of the plan, of any employer real property. {ERISA § 406(a)(1)(E)} There is an exception from the prohibited transaction rules for purchases of real estate within a qualified plan that are used for company purposes, called employer real property. {ERISA § 407(d)(4)} However, to take advantage of this exception, the company must have several pieces of property that are geographically dispersed, and, unfortunately, the DOL does not provide this exception for the first piece of property that is purchased. So, unless the company is buying several parcels of property, this exemption does not help.

The Final Straw—No Self-Dealing

The prohibited transactions above involve the plan and a party in interest, but many times a party in interest is also a plan fiduciary who manages the plan assets. Therefore, when considering any of the prohibited transactions in ERISA Section 406(a), as discussed above, a fiduciary must also consider the transaction under the light of ERISA Section 406(b). The prohibitions of Section 406(b) supplement the other prohibitions of Section 406(a) of ERISA by imposing on parties in interest who are fiduciaries a duty of undivided loyalty to the plans for which they act. {Labor Reg. § 2550.408b-2(e)} The rules of Section 406(b) are in place to deter a fiduciary from entering into a transaction when they have interests which may conflict with the interests of the plan.

ERISA prohibits fiduciaries with direct or indirect access to plan assets from using those assets for their own benefit, or for the benefit of another party other than the plan participants and beneficiaries. {ERISA § 406(b)} Specifically, ERISA states that a plan fiduciary shall not deal with the assets of the plan in his or her own interest; act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or its participants or beneficiaries; or receive any consideration from any party dealing with the plan in connection with a transaction involving the plan assets. {*Id.*}

In addition, Section 406(b) guards against "self-dealing," and, as such, a plan sponsor must not use the assets of the plan for his or her own personal gain. Conduct that is accepted in the real estate industry may be deemed self-dealing under this rule. It is not uncommon for members of the real estate community to hire their own affiliates to perform services, such as evaluating the property, leasing the property, or other management services relating to the property. In an ERISA context, this affiliate, in performing these tasks, could directly or indirectly benefit the owner of the property, the fiduciary, and the transaction would constitute a prohibited transaction. A fiduciary could avoid potential liability by hiring an independent, third-party property manager to manage and maintain the real estate. This property manager would handle all decisions related to the property such as valuation, leasing and maintenance.

If the Purchase Goes Wrong—Penalty for Prohibited Transactions

For qualified plans, the IRS has the authority to impose excise taxes on prohibited transactions. Under the Code, the definition of a prohibited transaction mirrors that of the ERISA definition but uses the term "disqualified person" in place of "party in interest"; yet, the two terms have similar definitions. {IRC § 4975(c)} Therefore, if a party in interest violates a prohibited transaction rule under ERISA, he or she also violates a prohibited transaction under the Code, and may be subject to excise taxes. For qualified plans, the Code imposes a first-tier tax on each prohibited transaction equal to 15 percent of the amount involved with respect to the prohibited transaction. {IRC § 4975(a)} If the transaction is not corrected within the taxable year in which the prohibited transaction was discovered, the IRS may impose a second-tier tax equal to 100 percent of the amount involved. {IRC § 4975(b)} Correction under the Code means undoing the transaction to the extent possible, but no less than putting the plan in a financial position not worse than it would have been had the disqualified person acted under the highest fiduciary standards. [IRC § 4975(f)(5)] This is a much higher bar than required under the IRS's Employee Plans Compliance Resolution System!

Raising the Red Flag—Annual Reporting

The plan must report on the annual Form 5500, filed with the DOL, the amount of any assets in the plan that do not have a readily determinable value on an established market, such as the New York Stock Exchange. If the plan invests in real estate, it is recommended that the fiduciary have an independent, third-party appraise the property each year. In a recent conversation with the DOL, the DOL agent indicated that the question on the Form 5500 was not intended to be used to flag a plan for a DOL audit. However, a fiduciary should be aware that answering such a question on the Form 5500, although required, could potentially draw attention to the plan by the DOL.

One More Expense—Bonding

The amount of the bond depends on the investments within the plan. Generally, the amount of the bond must be at least 10 percent of the assets in the plan, as of the preceding plan year, but no less than $1,000 and no more than $500,000 (or $1,000,000 if the plan holds employer securities). [ERISA § 412(a)] In order to rely on these bonding parameters, a plan must have at least 95 percent of the plan assets invested in qualifying plan assets, such as equities and bonds. [Labor Reg. § 2520.104-46] If less than 95 percent of a plan's assets are invested in qualifying plan assets, the plan must either be audited by an independent auditor each year or maintain a bond in the amount of at least 100 percent of the value of the non-qualifying plan asset.

Therefore, if a plan invests in real estate, which is considered a non-qualifying plan asset, with a fair market value in excess of 5 percent of the plan assets, the fiduciary must maintain bond coverage of at least 100 percent of the fair market value of the real estate property or have the plan audited by an independent auditor each year.

The Practical Side

Up to this point, the majority of the issues involving real estate in qualified plans can be resolved monetarily, albeit with lot of cash, that is, paying for an independent property manager, paying for an independent appraisal of the property, and paying for a bond to cover the assets (and, not incidentally, paying excise taxes for involving the plan in a prohibited transaction). More issues arise once the real estate is in the plan and can become even more complicated when a plan includes more participants than just the owner of the company. The practical issues involve individual access to the real estate investment, liquidity issues concerning distributions upon termination of a participant, payment of expenses relating to the real estate investment, and required minimum distributions (RMD). These issues vary considerably from a plan that covers more employees than just the owner (group retirement) to an owner-only plan.

Group Retirement Plan Issues

ERISA allows group retirement plans to have an array of options within the plan, such as self-direction of investments by participants and distribution options for the participants, so long as the plan provides access to these options on a nondiscriminatory basis. Put simply, a plan is not allowed to provide only the owners (and not the other plan participants) access to an option in the plan. Therefore, if an owner finds it attractive to invest in real estate and makes it an investment within the plan, participants, too, must have the ability to invest a portion of their account balance in the real estate investment. [ERISA § 401(a)(4)]

If a trustee invests plan assets in the real estate investment, a fiduciary must determine what happens when any participant terminates and requests a distribution, does he or she get a door or a window? I think not. Rather, because the real estate investment is not a liquid asset, the plan must either have enough cash or other liquid assets in the plan to pay the participant his or her share of the investment in the real estate or issue an in-kind distribution to the participant. Similarly, if the real estate is a directed investment by that participant, the plan will need to either distribute the parcel in-kind to the terminated participant or liquidate it in anticipation of distribution—perhaps at a less than favorable market situation.

If the participant requests an in-kind distribution, the terminating participant will own an undivided fractional interest in the real estate which could be transferred to an Individual Retirement Account (IRA), if allowed. When the plan eventually sells the real estate investment, this participant would receive his or her portion of the sale proceeds. In the meantime, the plan will have an asset partially owned by a non-employee. This scenario is likely unattractive to the plan sponsor. However, recall, that a plan cannot offer this in-kind distribution option to some participants, former owners, for example, and not to other participants. Therefore, if the trustee does not want to have plan assets owned by non-employees, the plan should not allow for in-kind distributions of real estate investments as an option.

Further, all expenses related to the real estate must be borne by the plan. Expenses related to the real estate may include, but are not limited to, closing costs, annual real estate taxes, fees, insurance, utilities, maintenance, repairs, and possible renovations. Therefore, the fiduciary should ensure there are sufficient liquid assets in the plan to cover these plan expenses.

If there are not sufficient liquid assets in the plan to pay benefits or expenses, an exemption from the prohibited transaction 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)} However, a fiduciary must use caution when taking advantage of this exemption, as it has the potential of evidencing improper diversification if used too much.

Lastly, a fiduciary must consider what happens if the plan needs to get rid of the property when the value is depressed. This may happen when the business owner needs money and wants to terminate the plan and take a distribution of the plan assets; or when the trustee is worried that the value of the property will decrease further and wants to cut its losses by getting the asset out of the plan; or, worse, when the plan sponsor realizes that the original property was involved in a prohibited transaction and the only way to fix it is to reverse the transaction, but cannot because there are insufficient liquid assets in the plan to effect the fix.

In such instances, the plan sponsor may think he or she is wise and offer to purchase the property out of the plan or, better yet, sell it to his or her father-in-law who wants the property. Both transactions constitute a prohibited transaction. One option would be for the owner to take a distribution of the property, but that only works if he or she is the only participant in the plan or, if there are other participants, when his or her account balance is greater than the value of the property. Even then, the distribution could be considered discriminatory, as it deprives all of the other participants the right to take their pro-rata share of the property as a distribution. If the property shoots up in value in the time following such a distribution, beware. This is a lawsuit waiting to happen. It is better in that circumstance to give every participant the opportunity to keep his or her share of the illiquid asset or to buy it out of the plan, hoping against hope that everyone but the owner will waive that right.

Fortunately, for depressed property, the DOL has special procedures and a prohibited transaction exemption where a party in interest can buy a piece of depreciated real estate out of the plan when there's no other available buyer. {Voluntary Fiduciary Correction Program, 71 FR 20261 (4/19/2006), § 7.4(F)} However, there are prescribed steps that must be taken before the sale occurs, and there is no guarantee that the DOL will approve of the transaction.

Owner-Only Plan Issues

When the only plan participant is the sponsor's owner, the investment in real estate is not so complicated. Because only the owner is eligible for the plan, there are no issues relating to access to plan investments or distribution options. If an owner decides to invest in real estate and the plan later terminates, the owner can simply sell the property in order to distribute the plan assets or transfer the entire property to an IRA, if allowed by the IRA institution. However, owner-only plans also face liquidity issues, specifically with partial distributions. If the owner is required to take a required minimum distribution of part of his account at age 72, the plan must ensure it has enough cash in the plan assets to process such distributions.

The Point?

One seemingly simple question from a trustee of a qualified plan—May we invest plan assets in real estate?—requires contemplation of rules both under ERISA and the Code and, potentially, hours of analysis. Yet, in the end, it is clear based on the above that a plan can invest in real estate. Although there are many complications involving the investment of real estate in a qualified plan, that is, 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—some trustees may still find the investment benefits outweigh the costs. Real estate can be a great way for a fiduciary to diversify plan assets while bringing income into the plan. Regardless, when investing qualified plan assets in real estate, a fiduciary should proceed with careful consideration. ■