Independent Actuaries, Inc.

Real Estate in Tax-Qualified Retirement Plans

Real estate is an investment that often nets significant returns and can help diversify an investment portfolio otherwise full of more traditional investments such as equities and bonds. However, there are numerous limitations and potentially negative tax consequences in the acquisition, maintenance and distribution of real estate as a tax-qualified plan asset. Plan sponsors and trustees must carefully consider several issues before including real estate as a plan asset.

The first issue to tackle is how to get real estate into a plan. Since ERISA and the Internal Revenue Code (the "Code") generally prohibit *contributions* of real estate to *pension* plans, the most common way to get real estate into a pension plan is to use existing pension plan assets to purchase real estate (in certain cases, plan sponsors may obtain permission from the Department of Labor in advance of contributing real estate to a pension plan; see http://www.dol.gov/ebsa/publications/exemption_procedures.html). 401(k) plans may also use existing plan assets to purchase property. Note that the general prohibition against *contributing* real estate to a plan only applies to pension plans—contributions of real estate to 401(k) plans are not outright prohibited by the Code. Furthermore, while either a pension or 401(k) plan may borrow money to purchase real estate (note, however, that it can be difficult to find a lender willing to loan to a plan), borrowing as such creates acquisition indebtedness that may in turn generate Unrelated Business Taxable Income ("UBTI").

Maintaining real estate as a plan asset presents a few issues. Real estate, which has values that may not be readily ascertained by reference to an open and established market, generally must be valued annually by an independent third party appraiser. An ERISA bond must be maintained that covers not less than the appraised value of the real estate—failure to maintain the appropriate bond or bond amount will subject the plan to costly annual audits. Taxes and costs to maintain or improve the property are generally paid by the plan (if the plan sponsor pays such expenses, the cost of the expenses would be considered a cash contribution to the plan subject to annual contribution limits). Profits from rent or sale of real estate inure solely to the benefit of the plan. UBTI is a possibility for any profits realized other than from the sale or rent of the property (farm income comes to mind as an example).

In practice, to facilitate distributions, real estate is generally sold and the proceeds distributed as cash. Most IRA providers will not accept a rollover of real estate (and the few providers that do, I am told, command exorbitant fees for their services). Federal law (ERISA) requires that all plan participants be granted equal rights, benefits and features—thus, if real estate is part of a pooled plan account, then in-kind distributions of real estate must be offered to all or no participants with investments in the pooled account. Distributions that are not rolled over are subject to a minimum 20% federal income tax withholding and may be subject to state withholding—sufficient cash must be available to cover the tax withholding.

In general, transactions with the plan or use of plan assets in a manner that directly or indirectly benefits a "Disqualified Person" constitute prohibited transactions subject to excise taxes of 15% to 100% of the amount involved in the transaction. Disqualified Persons include the plan sponsor, trustees and other fiduciaries, plan service providers, and many family members of these groups. Transactions such as buying or selling property between the plan and a Disqualified Person is a prohibited transaction. Use of real estate held by the plan by a Disqualified Person is a prohibited transaction (the plan sponsor, for example, uses a house held by the plan as his/her summer vacation home).

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Finally, many tax advantages associated with real estate may be lost by including real estate in a tax-qualified retirement plan. While real estate sales profits are generally subject to capital gains taxes, assets distributed from a tax-qualified retirement plan (or IRA) are treated as ordinary income.

Although there are numerous issues to consider, under the right circumstances, real estate is an attractive and appropriate tax-qualified plan investment. Plan sponsors and trustees must carefully consider several issues before including real estate as a tax-qualified plan asset and should contact their tax advisor and legal counsel before making any decisions regarding real estate in such a plan.

A BRIEF (REAL LIFE) CASE STUDY

Defined benefit plans can be an excellent tax deferral tool for individuals who have moved into the early stages of retirement. Earlier this year we were introduced to a business owner by a financial advisor we work with. He had recently sold his business to his son in a stock sale, retaining the business name and continuing to do a bit of consulting work. He needed very little current income to live on and was comfortable with a defined benefit plan designed to allow him to contribute $100,000 each year. In fact, it will give him the flexibility to contribute anywhere between about $50,000 and $160,000 each year, all towards his own benefit.

As an aside, his son decided to set up a new defined benefit plan himself, for the ongoing company. We designed a defined benefit plan that allows the son and his partner to put away $85,000 each per year towards their own retirement benefit, while contributing roughly 8% of pay to their three employees through their existing profit sharing plan.

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This article was written by Jason W. Douthit, J.D. Jason's work focuses on defined contribution plans and executive deferred compensation plans. He also represents employers in matters related to IRS and Department of Labor qualified plan correction programs. Jason holds a B.A. in Labor Studies and Philosophy, a J.D. from University of California at Davis School of Law, and is a member of the Oregon State Bar.

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