SUMMIT
Benefit & Actuarial Services, Inc.

REAL ESTATE AS A PLAN INVESTMENT

Investing in real estate within a qualified retirement plan is a nontraditional investment that requires careful consideration. Real estate includes but is not limited to Limited Partnerships, land, buildings, etc. Some issues are listed below; however they do not take into account issues such as changes in law or government policy, or unforeseen events. Please feel free to contact us if you'd like to discuss the issues as they relate to your Plan.

<u>Plan Document Language</u> – Does the Trust Document allow investment of Plan assets in real estate? The Trust Document must allow for this form of investment. Most Trust Documents do provide for this, or can be amended to do so.

<u>Valuation</u> – How do you value real estate investments? At least annually, all plan assets must be valued at their fair market value. If the real estate asset does not have a fair market value readily determinable on an established market (such as the New York Stock Exchange), then valuation requires an *independent, third-party appraisal*. You must determine if it is appropriate for the Trust or the Plan Sponsor to pay the fees associated with such appraisal. A company accountant or anyone related to the Plan or the real estate investment is not considered independent or third-party. The appraisal must be in writing, identifying the third-party appraiser and the methodology used to determine the fair market value. IRS Form 5500 asks if the appraisal was completed.If there is no appraisal, this could increase the chances of IRS audit or Department of Labor (DOL) investigation.

<u>Prudence and Diversification</u> – Do real estate investments impact prudency and diversification requirements? The Fiduciaries must take into consideration the composition of the Trust's portfolio. The Fiduciaries must diversify Plan investments to minimize the risk of large losses. There is neither an official list of prudent investments nor any official percentages or dollar amounts that are considered "diversified." However, IRS Form 5500 asks if the investment constitutes 20% or more of the total Plan assets and to disclose the amount of the investment. This could increase the chances of IRS audit or DOL investigation.

<u>Liquidity</u> –Are Plan assets tied up in real estate? The Fiduciary has an obligation to invest Plan assets in a prudent manner and maintain or attain sufficient liquidity to pay benefits when they are due.

<u>Fiduciary Bond Coverage</u> – Does the Fiduciary Bond cover real estate investments? A Fiduciary Bond provides protection to the Plan Trustees against loss by reason of acts of fraud or dishonesty. All Plans must have a bond that covers at least 10% of the Plan's assets. However, a Plan must obtain a larger bond if more than five percent of the investments in the Plan are <u>not</u> "Qualifying Plan Assets." Generally, real estate investments are not considered "Qualifying Plan Assets" and the bonding must be increased to 100% of the value of the non-qualifying assets. If the bond does not

adequately cover the non-qualifying real estate investments, an independent audit of the Plan is required. The cost to obtain an audit could be significant. The bonding coverage and independent audit questions are addressed on IRS Form 5500. Any failure to comply with the requirements could increase your chances of IRS audit or DOL investigation.

Benefits, Rights & Features – Do all Participants have the right to invest in real estate? If the Plan Document allows Participants to direct their own investments and real estate is considered an acceptable form of investment, the opportunity to invest in real estate must be available to all Participants on a nondiscriminatory basis. If some Participants are not allowed to invest in real estate while others are, additional nondiscrimination testing is required. This could incur additional administration fees.

In-Kind Distributions – Does the Plan Document allow in-kind distributions? If not, the Plan can be amended. However, the amendment and/or plan operation cannot directly or indirectly benefit only “Highly Compensated Employees”, as defined by the Internal Revenue Code. All participants must be given the opportunity to elect or waive the in-kind distribution. Prior to the in-kind distribution, it may be prudent to obtain a new fair market value of the real estate investment. If the participant wants to roll the investment to an IRA, the participant must find an institution to accept it. Such IRA fees can be costly. If the investment cannot be rolled to an IRA, it is taxable income to the participant.

Debt Financed Income – Income earned by a Trust as a result of debt-financing, for example gains on property purchased via a mortgage, could be taxable to the Trust at trust rates. IRS Form 990-T and a corresponding state form may be required, perhaps annually.

Unrelated Business Taxable Income – Does the investment of real estate result in unrelated business income tax? If the Trust has so many real estate investments that it is deemed to be operating as a business rather than investing assets for retirement, the earnings become subject to unrelated business taxable income. If an investment is determined to be subject to unrelated business taxable income, IRS Form 990-T and a corresponding state form may be required, perhaps annually.

Mortgage – Can the Trust obtain one if needed? While the Trust might have the appropriate language, will a bank or lending institution agree it is a good credit risk? Typically, the Plan and Trust would state that any attempt by a Participant or Beneficiary to assign, alienate, sell, transfer, pledge or encumber his or her benefits should be void.

Maintenance – Real Estate could require maintenance, improvements, taxes, etc. Plan assets are used for these expenses. This depletes liquidity.

Prohibited Transactions – Does the real estate investment benefit a “party-in-interest” (as defined by the Internal Revenue Code)? The Fiduciaries are obligated to maintain the Plan and Trust solely for the exclusive benefit of Participants and their Beneficiaries. If the purchase or use of real estate directly or indirectly benefits anyone else, such as a

Fiduciary or other party-in-interest, it will result in a prohibited transaction. This could subject the party-in-interest to a government-imposed excise tax of 15 to 100 percent of the value of the transaction. It is important to identify if there are any parties-in-interest involved with a real estate transaction. For example, the Plan's purchase of property from the business owner, the Plan's property being rented to the child of a Participant or the Plan's building being used by the Plan Sponsor would be prohibited transactions. There is a DOL procedure to apply for an exemption from the prohibited transaction rules. The application process can be costly, should be addressed before the transaction takes place, and you should be prepared for any potential ramifications if the DOL does not approve the transaction.