

Overview of important limitations, complications, restrictions and requirements of investment in Real Estate (rental property) by a qualified retirement plan

Certain important limitations, complications, restrictions and requirements may exist when a qualified retirement plan invests in real estate, especially if the intent is to offer the property for rent. These considerations are outlined in general terms. Other considerations exist which should be explored prior to investment by the plan.

Summary of Analysis:

Two issues are in play with the investment by the plan in assets which are not readily available on an established market: 1) Prohibited Transactions and 2) Assessment of tax on Unrelated Business Taxable Income

A Prohibited Transaction can occur if a Party in Interest (as defined under ERISA) or a Disqualified Person (as defined under Internal Revenue Code §4975(e)) engages in transactions with the Plan.

A Disqualified Person includes, in part, the Plan Trustee, the Employer or Plan Sponsor, a plan participant, a 50% or more owner of the Employer, family members of disqualified persons, entities owned 50% or more by any of the foregoing, and officers, directors, 20% shareholders and highly compensated employees of the any of the foregoing.

Under IRC §4975(c)(1)(A) a Disqualified Person may not sell or exchange property to the Plan. This includes direct and indirect transactions. If the ownership or management of the real estate investment can be deemed to be a Disqualified Person(s), either directly or indirectly, then a Prohibited Transaction may have occurred.

Additionally, under IRC §4975(c)(1)(E) a transaction is prohibited if a fiduciary deals with income or assets of the Plan in his own interest. Based on specific facts and circumstances a prohibited transaction could occur if the investment is of a nature that could benefit, either directly or indirectly, the Plan Trustee or the Plan Sponsor.

Separate from concerns with respect to the rules regarding Prohibited Transactions is the issue of Unrelated Business Taxable Income (UBTI). If the Plan conducts an active trade or business (as opposed to deriving income from an investment activity) the income derived from such a business is taxable under the IRC §§511 through 514. Such an activity is considered to go beyond the Plan's tax-exempt purpose of accumulating investment interest.

A trade or business is deemed to be an activity carried on for the production of income from the sale of goods or the performance of services (IRC §513(c)). If the Plan derives income from a partnership (or limited liability company), the character of the income passed through to the Plan as a partner is UBTI to the extent the income is derived from

an active trade or business (IRC §512(c)). This rule specifically applies even if the Plan is a limited partner in the partnership. Investments by a plan in an S-corporation always give rise to UBTI.

Both the issues of prohibited transaction and UBTI must be examined carefully. Based on the structure of the business and its relevant parties a prohibited transaction could occur. The character of the income earned by the Plan from its investment would indicate whether UBTI applies.

By exercising care that the investment is not directly or indirectly owned or managed by a disqualifying person the chances of a prohibited transaction occurring are minimized. Further, it is important that neither the Employer nor Trustee receives any benefit from the Plan's investment, whether that benefit is direct or indirect.

Note that the IRS assesses a 15% excise tax on the amount involved in a prohibited transaction for each part of a year involved. The prohibited transaction would also need to be corrected or "undone" in a manner that would not cause the plan to be in a worse financial position. Separately the Department of Labor has the authority to impose civil penalties against a plan fiduciary engaging in a prohibited transaction.

UBTI would likely require the Plan to file Form 990-T (due April 15th after the close of the year) to report and pay the tax. The UBTI earned (less a \$1,000 automatic deduction) would be taxed under the tax rates for estates and trusts. The table accelerates quickly from 15% for income between \$0 and \$1,950 to a rate of 35% for income in excess of \$9,550.

CONCLUSIONS:

Investment by ownership of real estate may be permissible if the venture is not directly or indirectly owned or managed by a disqualifying person. Further, it is important that neither the Employer nor Trustee receives any benefit from the Plan's investment, whether that benefit is direct or indirect.

Investment by the Plan may give rise to UBTI. UBTI would require the Plan to file Form 990-T (due April 15th after the close of the year) to report and pay the tax. The UBTI earned (less a \$1,000 automatic deduction) would be taxed under the tax rates for estates and trusts. The table accelerates quickly from 15% for income between \$0 and \$1,950 to a rate of 35% for income in excess of \$9,550.

Generally, plans may invest assets in real estate. A plan must have access to enough cash to pay expenses and benefits. Large investments in real estate can cause issues when payments must be made since deposits from outside the plan would be considered contributions to the plan. A prohibited transaction could occur if the plan sponsor, trustee or other disqualified person engages in the real estate transaction with the plan. Income earned from real estate investments in the plan may be subject to UBTI especially if the real estate is subject to debt.

Plans with more than 5% of the assets deemed “non-qualifying” (cannot be readily valued on secondary markets) need bonding equal at least 100% of the value of the non-qualifying assets.

A plan fiduciary is required to exercise prudence and diversification when investing plan assets. If most of the plan assets are invested in a few specific investments (especially “non-qualifying”), the DOL or IRS could determine that the fiduciary is in breach of his duties.

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