Using Real Estate and Alternatives Inside Pension Plans

Expanding Options for the Non-Traditional Investor

By David Podell, Business Benefits Consultants

In recent years, many high-net-worth individuals, solopreneurs and business owners are seeking alternative ways to diversify their portfolios. For those who feel they've already diversified across traditional assets and are looking for greater control or more lucrative growth potential, there are increasingly innovative solutions available, especially within their pension and retirement plans.

Non-traditional assets, such as syndicated real estate, cryptocurrencies, private equity and private credit, can be incorporated into retirement plans like profit-sharing and 401(k) plans. These options are appealing to business owners who are not only looking to generate more wealth but also prefer "different" control over their investments and lower correlation to the markets.

There are complexities when using these assets in qualified plans, such as legal and regulatory constraints, that need to be carefully navigated. There are potential pitfalls, including UBIT (unrelated business income tax) rules and liquidity issues that can arise from holding alternative assets in retirement accounts.

The ideal clients for this strategy are solopreneurs, and business owners. It's important to have enough liquidity in traditional assets before holding alternative investments in a Defined Benefit (DB) or Defined Contribution (DC) Plan. These types of clients may be concerned about the lack of control they have. Many have had a bad stock market experience or simply don't trust Wall Street. In particular, they may prefer passive income strategies through real estate. They must be open to complexity in their investments, understanding that non-traditional assets require deeper knowledge and sometimes more involvement.

For the right clients, alternatives can provide valuable diversification. A clear understanding of how to structure these investments in compliance with retirement account rules is critical.

Profit sharing plans and 401(k)s are both popular retirement plans for solopreneurs and small businesses. The flexibility and tax advantages of these plans make them a natural place to consider for non-traditional investments. The ability to defer taxes on high producing investments while obtaining a deduction is an advantage.

Syndicated real estate allows investors to pool their resources together and invest in larger properties or development projects that they otherwise couldn't get into individually. In the context of a profit-sharing plan, syndicated real estate can provide passive income through rent and appreciation. It also allows for diversification into a tangible asset class that is not correlated with the stock market.

There are several reasons why real estate, particularly syndicated real estate, is ideal for profit-sharing plans:

- Income generation: Real estate can provide steady cash flow, which is beneficial for retirement income. The rent generated by properties can be reinvested within the profit-sharing plan.
- Appreciation potential: Over time, real estate tends to appreciate in value. This offers potential capital gains on top of regular income. When a deal is sold, you can invest in another one without realizing the gain and continuing to defer.
- Hedge against inflation: Real estate is often seen as a good hedge against inflation, as rents and property values tend to increase with inflation.
- Syndicated real estate in a profit-sharing plan can also be structured in a way that provides diversification across different property types and geographical locations. This reduces the risk of investing in a single property or market.

Pitfalls to be aware of

While syndicated real estate offers many advantages, it is important to consider the liquidity constraints. Real estate is inherently less liquid than stocks or bonds, meaning it may be difficult to sell quickly if funds are needed. Additionally, if the real estate generates unrelated business taxable income (UBTI), it could trigger tax penalties within a qualified retirement plan.

Private equity and private credit in qualified plans

Private equity and private credit are alternative investments that are becoming increasingly popular among sophisticated investors. Private equity involves investing directly in private companies, while private credit involves investing in debt issued by private firms. Both have the potential to provide higher returns than traditional public market investments. These have become very accessible now when an investor is accredited and obtains these investments through a financial advisor.

In profit-sharing plans, these investments can be structured in a way that aligns with the account holder's long-term financial goals.

- Private equity offers the potential for high returns by investing in growing companies, which may eventually go public or be sold at a premium.
- Private credit can generate steady income from debt issued by private companies, often with higher interest rates than publicly traded bonds. The biggest risk here is defaults.

Using funds is the most common way of gaining access to these investments. Private equity may take years to mature, and private credit can be more vulnerable to the financial health of the borrowing companies.

Traditional safer assets in defined benefit plans

While profit-sharing and 401(k) plans allow for a broad range of alternative investments, DB Plans are better suited for more conservative, income-generating or moderate assets. A DB Plan, which promises a specific retirement benefit based on factors such as salary and years of service, is designed to offer predictable, stable returns. DB plans have a lot of flexibility but an average target of 6% still needs to be met in most designs.

Traditional, safer assets such as bonds, treasury securities or other fixed-income instruments should be the core assets in a DB plan because they are relatively low-risk and provide stable returns. This is especially important for business owners who want to ensure they can continue using the large tax deductions each year without over/under funding issues.

Despite all these advantages, there are several pitfalls to consider when holding alternative assets inside retirement plans.

Unrelated business income tax (UBTI)

One of the most significant concerns when holding alternative assets like real estate in a qualified plan is the potential for UBIT. If the asset generates income that is unrelated to the retirement plan's primary purpose (e.g., income from leveraged real estate), it may trigger UBIT, which is taxed at the corporate tax rate. This can erode the tax advantages of holding such investments in a qualified retirement plan.

Liquidity concerns

Many alternative investments, such as real estate and private equity, are inherently illiquid. Unlike publicly traded stocks and bonds, which can be sold relatively easily, these assets may require a longer time horizon to generate returns or may be more difficult to liquidate in times of need. For individuals who need access to liquidity, this could pose a challenge. If the retirement plan holder requires immediate access to cash, they may be forced to sell the assets at an unfavorable time or even borrow against their plan.

Complexity and regulatory issues

Alternative investments often require more expertise and management than traditional assets. This includes understanding the complexities of investment vehicles, tax implications and potential risks. In addition, there are strict regulatory rules governing what types of investments can be held within retirement plans, and non-compliance can result in penalties or loss of tax-deferred status. Investors must work closely with experts in this area to ensure their retirement plans comply with IRS rules and regulations. The trustee is responsible for making the right choices to align the plan documents, to meet their long-term financial goals.

By expanding their investment horizons, they can unlock new growth potential while ensuring their retirement savings are well-positioned for the future. With the right strategy, the incorporation of alternative assets in retirement plans can provide powerful results. ▶

About the Author

David Podell started Business Benefits Consultants when he identified a niche space that was filled with complexity and a need for expertise in the Tax Mitigation arena. He has lectured extensively and is a sought out specialist in Defined Benefit and Cash Balance Plans. He has been featured in Forbes, American Institute of CPAs, CPA Practice Advisor and multiple small business journals. He has become an acclaimed speaker and educates the accounting industry as a certified CPE Sponsor. His firm is commissioned by Tax Strategists and Financial Advisors to provide an outsourced solution that allows those professionals to implement and manage these plans for their clients.