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The PRS Report

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Non-Qualifying Assets - To Invest or Not to Invest? That is the Question!

Did the plan hold any assets whose current value was neither readily determinable on an established market nor set by an independent third party appraiser?

The above question, which appears in the “Compliance” section of Schedule I of Form 5500 (Schedule H for large plans), is asking about the plan’s investment in “non-qualifying assets.” For this newsletter non-qualifying assets are assets, such as real estate, whose current value is not readily determinable on an established market.

Sounds like a pretty innocuous question, no? But think about this! Over the last few years, the Department of Labor (DOL) has audited plans sponsored by several of our clients. What is common to each of those plans is that the above question was answered “yes” on each plan’s Schedule I (or H). (This does not imply that every client who answered “yes” was audited.)

Just a coincidence you say? Well, ponder this! In each of the audits, the DOL honed in almost immediately on the assets in question, requesting exhaustive documentation. From the perspective of this author who has over twenty years of experience in the field, it sure appeared that these plans were targeted for audit because the plans invested in non-qualifying assets which had not been appraised by an independent third party appraiser for the plan year in question.

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A host of questions arise from the above narrative which we will try to answer:

1. **What types of assets are included in the above category?**
   Some examples of such assets are real estate, non-publicly traded limited partnerships, artwork and coin collections. What's common to each of these investments is that they are all assets whose current value is not readily determinable on an established market but must be set by an independent third party appraiser.

2. **If investing in non-qualifying assets is permissible, why should the DOL target such plans for audit?**
   The IRS requires that the current value of plan assets be determined each year, although it does not require that assets be valued each year by an independent third party appraiser. Indicating on Schedule I (or H) that non-qualifying assets were not appraised by an independent third party appraiser raises a red flag. The DOL's domain is thought to be the plan participant, while the IRS is generally responsible for the taxation side of the pension equation. It's possible that what concerns the DOL is the payment of benefits to plan participants. For example, when a participant terminates employment and is entitled to and requests a distribution from the plan, how is the participant's benefit payable determined if the value of a portion of the assets was not determined on an openly traded market? Will the participant be shortchanged upon receiving a distribution? Almost always, investing in non-qualifying assets is the idea of the owners of the business. Playing devil's advocate, you may allow the plan to set up individual brokerage accounts so that the non-qualifying assets are an investment in the segregated account of the owner of the business and the rank and file participants' account balances are invested exclusively in qualifying assets which are valued daily. This opens another set of issues such as discrimination, should you not offer the same investment opportunities to the staff that are offered to the owners of the business. It should be noted that in the DOL audits held in our office, individual brokerage accounts did not placate the DOL which continued to request documentation regarding the non-qualifying assets.

3. **Why not simply hire an independent third party appraiser to value the non-qualifying assets annually?**
   This is the correct approach. If the non-qualifying assets are valued annually, the red-flag question will

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be answered “no” on the Schedule I or H and no red flag will be raised. Good luck obtaining an annual valuation of the plan’s investment in a real estate investment trust (REIT), non-publically traded limited partnerships or even real estate. Most times, as one small investor out of many, you don't have the leverage to demand an annual appraisal of the assets.

4. **Why should you, the plan sponsor, care if your plan gets audited by the DOL?**
   An audit by the DOL will probably increase your fees since you will want a pension professional (a Third Party Administrator or ERISA attorney) with experience in dealing with governmental agencies to handle the audit. Such professionals will charge for their services. If you decide to handle the audit in-house, you will find yourself devoting time to matters which are not the core concern of your business. Moreover, when a plan is audited, all plan matters are open for investigation. For example a DOL audit that begins by focusing on non-qualifying assets may shift to requesting documentation to verify whether 401(k) contributions have been timely deposited. Do you really need the DOL poking around the plan?

   Without the annual appraisal of the non-qualifying asset, the small employer may find that digging up past documentation due to a DOL audit may not be worth the trouble. Regardless, a DOL audit is not something the plan sponsor should take lightly.

5. **Why invest in such assets if indeed such an investment may lead to a DOL audit?**
   Plan sponsors who invest in non-qualifying assets usually are searching for an investment return for the plan in excess of what traditional qualifying assets (stocks, bonds, mutual funds, e.g.) are expected to yield.

6. **Are there additional issues to consider for plans that invest in such assets?**
   Plans that invest in non-qualifying assets must increase fidelity bond coverage in order to avoid the annual requirement to obtain the opinion of an independent qualified public accountant (this accountant’s opinion is different from the independent third party appraisal). Other issues which the plan sponsor must consider before investing in non-qualifying assets are general fiduciary considerations to invest the assets of the plan prudently, potential discrimination issues as alluded to above, unrelated business taxable income, correctly titling the non-qualifying assets in the name of the plan so that

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the investment in the asset is not a prohibited transaction and the additional cost of obtaining an annual appraisal of the non-qualifying asset when it is possible to do so. Perhaps a large employer which has a cadre of in-house attorneys at its beck and call may be of the opinion that the lure of high-yield non-qualifying assets is worth the cost of hiring an appraiser to annually value the non-qualifying assets. For the small employer though, the fees incurred in paying an appraiser annually may make the asset a lot less attractive.

7. **Are there any instances in which it may be wise for a plan sponsor to invest in such assets, despite the increased risk of a DOL audit?**
   Although one may conclude from reading the above that investing a portion of the plan's assets in non-qualifying assets is never a good idea, we would be remiss if we did not point out that there are specific scenarios in which investing in non-qualifying assets is a suitable course of action, despite our reservations detailed above.

   One example would be a company whose core business is real estate development. Such a company may be acutely aware of potentially lucrative real estate opportunities which are expected to yield returns far in excess of what could be expected from the more traditional qualifying assets such as stocks or bonds.

Conclusion

The investment of plan assets in non-qualifying assets is laden with complexity and potential pitfalls. A plan sponsor who wishes to do so, should first consult with us before proceeding. First and foremost, we will be able to determine if the desired asset is a non-qualifying asset. If so, we will also be able to give you guidance which will limit the potential fallout of such a move.

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