IRAs OWING TAX:
An Overview of UBIT

Your IRA May Owe Taxes

Most investors and investment professionals do not realize that an IRA can owe taxes in certain situations that are considered "unrelated" to the intent of an IRA's tax-exempt status. Income and capital gains from investments in an IRA are typically exempt from taxation. However, it's important to understand common scenarios where **Unrelated Business Income Tax (UBIT)** may apply:

1. The IRA is invested into an operating business that generates "ordinary" income as opposed to passive, investment income
2. The IRA has borrowed money to purchase an investment (such as a mortgage on real estate)
3. The IRA has invested into an LLC/LP that is either an operating business or has taken on leverage
4. The IRA buys and sells multiple properties without intent to hold the properties for long-term investment

UBTI – Taxable income from unrelated activity
UDFI – Taxable income from leveraging in IRA
UBIT – Tax Due as result of UBTI or UDFI

What is UBTI?

When income from an IRA is generated from an operating business, that income is considered to be **Unrelated Business Taxable Income (UBTI)** and all of the income generated from that business may be subject to UBIT. For example, if an IRA opened a Subway in an LLC, income from that restaurant would be considered unrelated to the IRA's tax-exempt status. IRAs are intended for long-term, passive investments. Rental income, interest income, royalties and capital gains are all typically exempt from taxation in an IRA.

What is UDFI?

Additionally, if income is generated as a result of debt financing inside the IRA, a portion of the annual income (and future capital gains) generated will be considered **Unrelated Debt Financed Income (UDFI)** and will be subject to UBIT. For example, your IRA purchases a $100,000 property with 40% down from the IRA and 60% from a non-recourse loan, 60% of the income will be considered UDFI and subject to UBIT. Additionally, when you sell the property, 60% would be subject to standard capital gains rate (not trust tax rates).

UBIT Tax Rates (Based on Trust Tax Rates)

If Taxable Income is:	The Tax is:
Not over $2,500	15% of the taxable income
Over $2,500 but not over $5,800	$375 plus 25% of the excess over $2,500
Over $5,800 but not over $8,900	$1,200 plus 28% of the excess over $5,800
Over $8,900 but not over $12,150	$2,068 plus 33% of the excess over $8,900
Over $12,150	$3,140.50 plus 39.6% of the excess over $12,150

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Avoiding UBIT

Below are some helpful strategies and tips on ways to avoid paying UBIT:

1. **Invest in a C-Corp:** If your IRA is going to invest in an entity that will be considered an operating business with ordinary income, if that entity is a C-Corp, your IRA will not be subject to UBIT. C-Corps pay tax at the Corporate Tax Rates prior to distributing earnings to it's shareholders.

2. **Partner Instead of Borrowing:** If you need additional funds to complete a real estate transaction, consider bringing on an equity partner instead of borrowing funds. If additional funds are obtained from an equity partner, UDFI will not apply.

3. **Sell the LLC, not the Real Estate:** If your leveraged property is owned inside an LLC, consider selling the LLC instead of the property itself and avoid UDFI.

4. **Leverage Assets in a 401(k) Plan:** If eligible, consider opening a Solo/Individual 401(k) plan. Section 401 is more liberal than 408 (IRAs). UDFI tax on capital gains does not apply inside a 401(k) plan.

5. **Pay off Loan 12 months Prior to Sales:** UDFI is based on the average loan amount in comparison to the cost basis over the 12-month period prior to the sale of the property. If the loan is paid off more than 12 months prior to the sale of the property, UDFI would not apply.

6. **Do a 1031 Exchange:** If UDFI will apply at the sale of your IRA-owned property, consider utilizing a 1031 exchange to defer the UDFI tax due.

Case Study: Buying Real Estate in an IRA with Leveraging

1. Bob Smith has a Self-Directed IRA with $100,000 in cash. He would like to purchase a rental house for $140,000 by making a down payment of $70,000. The seller agrees to hold non-recourse financing at an 8% interest only 30-year non-recourse note..
2. 50% of Bob's net income from this property will be subject to UDFI because that is the average loan to cost ($70,000/$140,000) over the prior 12 months. If the net rental income is $5,000, 50% (or $2,500) is subject to UDFI. Bob can then deduct interest and deprecation for 50% of the property. This final net number is the amount that would filed on IRS Form 990-T. This calculation and filing would have to be done annually by Bob's CPA. Remember, if the final taxable amount is less than $1,000, no filing or tax is due. This is often the case.
3. Now, let's assume Bob sells the house 3 years later for $160,000 (a $20,000 profit). In that year, in addition to net income earnings subject to UDFI, Bob will have to pay UDFI on his profit proportionate to the average loan to cost over the prior 12 months.
4. If the mortgage balance is still $70,000, then of his $20,000 profit, 50% (or $10,000) would be subject to capital gains tax of 20% ($2,000). The 990-T filing would be prepared by Bob's accountant and sent to his IRA Administrator (such as Midland) for signature and payment to be issued from the IRA by tax filing deadline.

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Commonly Asked Questions

1. **If my deal requires leveraging, should I use personal funds instead of IRA funds for the deal to avoid paying UBIT?** Depending on the transaction, after depreciation and interest deduction, and the fact that the first $1,000 of net income is not taxable, the tax due may not be as bad as you might think Remember, only a percentage of the income is subject to taxation. In comparison, with personal funds, 100% of profits may be subject to taxation. Run the numbers, it's usually not as bad as you think.

2. **If I have a net loss after expenses, am I able to carry forward that loss to future years?** In certain circumstance, yes, you are able to carry forward prior year losses to mitigate future UBIT. You are not required to file a 990-T in years when no tax is due. However, in order to carry losses forward, you must file the 990-T for each year that a loss occurs.

3. **If required, how do I file a 990-T for my IRA?** Work closely with a competent tax advisor that understands SDIRAs and the possible tax UBIT implications. Your CPA will prepare the 990-T filing and provide to Midland for filing. You as the account holder will complete a Payment Authorization Letter (PAL) and approve of the 990-T preparation. Midland will then file the 990-T and make the tax payment from your IRA.

4. **What Tax ID should be used for the 990-T filing?** Typically, for most filings, an IRA will use the custodian's tax ID. If UBIT or UDFI tax is due from the IRA, the IRA must obtain its own Tax ID for banking purposes only. That Tax ID will be used for the 990-T filing. The filer's name should be listed as "Midland IRA, Inc. FBO {Client's Name} # {Client's Midland Account Number}". This filing is not related to the investor's personal tax return in any way. It's very easy to obtain a new Tax ID Number for your IRA online at irs.gov.

5. **If I'm buying and selling properties in my IRA, how many is too many before my IRA would be considered to operating a business and be subjected to UBIT?** There is no black and white answer to this question. There are many factors that come into play. It is best to consult your CPA or tax advisor in all of these situations as they will best understand your full investment scenario.

6. **If my IRA is invested in an operating business that also has leverage, will the income be double taxed?** Income can only be considered either UBTI or UDFI, both not both. For an operating business, all of the income will be considered subject to UBIT. For leveraged properties, only the portion of income derived from the leverage will be subject to UBIT.