Decoding Unrelated Business Taxable Income (UBTI) within an IRA

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Your client's IRA owns an asset or interest that produces unrelated business taxable income (UBTI). Their IRA may be subject to an unrelated business income tax (UBIT).

What to know…

How is UBTI generated?

If your client's IRA owns an asset or interest that produces unrelated business taxable income (UBTI), their IRA may be subject to an unrelated business income tax (UBIT) pursuant to Sections 511-514 of the Internal Revenue Code. However, before we can address the tax, we must first identify situations when unrelated business taxable income is generated.

Unrelated Business Taxable Income applies if ALL of the following are true:

- Income is derived from "trade or business" activity (i.e., sale of goods and services).
- Business activity is not substantially related to exempt status.
- Business is regularly carried on by the organization for the production of income.
- There is a special rule for trade or business regularly carried on by a partnership of which the exempt organization is a member. Refer to IRC Section 512(c) and Reg. § 1.512(c)-1

Generally, IRA investments that can generate UBTI include limited partnerships, limited liability companies, and any investment that incurs debt financing and/or is involved in an unrelated business. Most passive investment income — including interest, dividends, royalties, and rent — is exempt from UBIT. However, an investment that generates income with debt financing (for example, purchasing real estate with a non-recourse loan in an IRA) is responsible for UBIT in direct proportion to the gain/income that's debt financed.

Code Levels The Playing Field But UBIT Can Come Out Ahead

The IRC Code Sections 511 through 514 imposes the tax on the business income of certain tax-exempt organizations, in this case IRAs, in order to level the playing field with other taxable entities. So if your client's IRA invests in an LLC that purchases a convenience store, this would be considered a business operation unrelated to the primary purpose of the IRA. In this case, the net income will be taxed at the trust tax rate as Unrelated Business Income Tax (UBIT). The key is to run the numbers for the various scenarios for investments made within and outside of the retirement account.

Guidance Using Debt-Financing In An IRA

One situation where UBTI comes into play but may still work to the advantage of a client is with debt financing in an IRA. For example, if the IRA investment earned $50,000 in gross income on a 25% debt-finance property, $12,500 would be subject to. If we then calculated any allowable deductions directly related to the property of $5,000 (after the 25% allocation) for example, $7,500 would be the unrelated business taxable income before the specific deduction allowable. After the specific (maximum allowable) deduction of $1,000, the remaining unrelated business taxable income of $6,500 would then be subject to UBIT. Applying the trust tax rate applicable as referenced in the Form 990-T instructions (2014), the tax would be $1,396.

How does this compare to the scenario where the real estate investment was made with discretionary funds? If you had made the real estate investment outside of the IRA with discretionary funds, your taxable income would be 100% of gross

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income earned not just the debt-financed portion. So $30,000 of gross income would be included in your Federal and State adjusted gross income and you would owe income tax at that marginal bracket. This tax could range anywhere from 10 - 39.6 percent ($3,000 - $11,800) depending on your filing status and other taxable income, also taking into consideration the taxpayers itemized and/or standard plus exemption deductions.

Additional Guidelines When Using Debt-Financing

Advisors and tax professionals are showing an increased interest in familiarizing themselves with the tax reporting of investing in leveraged real estate using IRA funds because of the growing interest and use by their clients. The combination of IRA funds and the use of debt create a unique reporting requirement, but not one that can't be decoded.

The debt-financed real estate held by your client's IRA account could be subject to UBTI if the property is producing rental income and/or has been sold in the current tax year. Clients that may have sold debt-financed property and have realized a short-term or long long-term capital gain from the sale, that they may be required to make estimated payments on the tax due to avoid an estimated tax penalty.

As noted earlier, whenever debt is used by a tax-deferred or tax-exempt entity (with some exceptions), tax is applied to that portion of the gain that is debt-financed. This income is called unrelated debt financed income or UDFI. Taxes on both are calculated and reported on IRS Form 990-T.

If debt-financed property(s) and Schedule K-1 income have generated less than $1,000 total combined taxable income, there is no requirement to file Form 990-T for the current tax year. Each Individual Retirement Account owner would need to fill out a 'No Filing Required' Form and worksheet each calendar year for their custodian to keep for their records. "However, if you want to take advantage of any net operating loss(es) that you may be entitled to," notes Farkas, "you must file on an annual basis to be allowed to carry forward any loss(es) to future years and thereby offset any gain(s).

IRAs that receive more than the current $1,000 UBTI specific deduction exclusion must file Form 990-T with the Internal Revenue Service on or before the April 15 deadline. Form 990T payments must be made from the IRA's assets, and typically custodians need to receive direction to pay these taxes at least 10 days before the due date.

Additional Resources:

See IRS Publication 598 for additional rules for debt-financed property and income tax.

Investors should consult professionals who are familiar with the IRS rules related to unrelated debt financing and unrelated business income tax (UBIT).

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