



EQUITY  
TRUST®



Decoding Unrelated Business  
Taxable Income (UBTI) Within an IRA

## Section 1:

# What are UBTI and the Unrelated Business Income Tax (UBIT)?

## Sections 511-514

Sections 511-514 [NOTE: all references herein to Sections refer to Sections of the Internal Revenue Code of 1986, as amended] impose a tax on the business income of certain tax-exempt organizations in order to level the playing field with taxable entities - Reg. § 1.513-1(b)

## How is UBTI generated?

- Income must be from a trade or business regularly carried on – Section 512(a) and Reg. §§ 1.512(a)-1 and 1.513-1(b) and (c)
- Income must be unrelated to exempt function – “not substantially related” - Section 513 and Reg. § 1.513-1(d)
- Trade or business is any activity carried on for the production of income from selling goods or performing services within the meaning of Section 162 - Reg. § 1.513-1(b)
- Special rule for trade or business regularly carried on by a partnership of which exempt organization is a member – Section 512(c) and Reg. § 1.512(c)-1

## What entities/organizations are subject to UBIT?

- Section 408(e)(1) makes these provisions applicable to IRAs (not to the IRA owner)
- Special rule for qualified retirement plans under Section 401(a) with exempt trusts under Section 501(a) – any trade or business carried on by such trust or by a partnership of which it is a member is considered an unrelated trade or business – Section 513(b)
- These rules and other rules apply to many other tax-exempt entities, but our focus is on IRAs (and qualified retirement plans)

## Section 2:

# How is UBTI calculated? Section 512

## What income is included?

Gross income derived from any unrelated trade or business regularly carried on – Section 512(a)

## What deductions are allowed?

- Deductions allowed which are directly connected with carrying on such trade or business – Section 512(a) & Reg. § 1.512(a)-1(b)
  - To be “directly connected,” expenses must be proximately and primarily related to the business
  - Expenses, depreciation and similar items attributable solely to the conduct of the unrelated business activities are deductible if satisfy requirements of Sections 162, 167, or other relevant Code provisions
- Net operating loss (NOL) deduction per Section 172, except that NOL for taxable year, NOL carryback or carryover to any taxable year, and NOL deduction for any taxable year are determined without taking into account any amount of income or deduction excluded in the calculation of UBTI – Section 512(b)(6) and Reg. §§ 1.512(b)-1(e) & 1.514(a)-1(b)(5)
- Deductions allowed by Section 170 for charitable contributions and gifts whether or not directly connected with carrying on trade or business, but limited to:
  - 10% of UBTI, in the case of an organization described in Section 511(a) – Section 512(b)(10)
  - The limitations prescribed by Section 170(b)(1)(A) & (B) with respect to the UBTI (rather than adjusted gross income), in the case of a trust described in Section 511(b) – Section 512(b)(11)
- Specific deduction of \$1,000 (except for purposes of computing NOLs under Section 172 and Section 512(b)(6)) – Section 512(b)(12)

## What income is excluded?

- “Modifications” to gross income and deductions
- Facts and circumstances to determine actual nature of particular item of income – Reg. § 1.512(b)-1
- Not excluded to extent attributable to debt-financed property – Section 512(b)(4)
- Dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities (and all deductions directly connected with such income) – Section 512(b)(1)
- Royalties, whether measured by production or by gross taxable income from the property (and deductions directly connected with such income) – Section 512(b)(2)
- Rents, subject to special rules (and all deductions directly connected with excluded rents) – Section 512(b)(3)
- Gains or losses from sale or exchange of property, subject to special rules – Section 512(b)(5)

## Section 2:

### How is UBTI calculated? Section 512 (cont'd)

#### Special rules for rents – Section 512(b)(3) and Reg. § 1.512(b)-1(c)

- Exclusion applies to all rents from real property and personal property leased with such real property, if rents attributable to personal property are an incidental amount (generally, not more than 10%) of total rents received – Section 512(b)(3)(A) and Reg. § 1.512(b)-1(c)(2)(ii)(b)
- Rents not excluded under certain circumstances:
  - If more than 50% of total rent under the lease is attributable to personal property – Section 512(b)(3)(B)(i)
  - If the amount of rent depends in part on the income or profits derived by any person from the property leased (but not if based upon receipts or sales) – Section 512(b)(3)(B)(ii)
  - To the extent the property generating the rent is debt-financed – Section 512(b)(4)
  - Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property (e.g., hotels, parking lots, warehouses, storage garages) – Reg. § 1.512(b)-1(c)(5)

#### Special rule for gains or losses from sales or exchanges of property - Section 512(b)(5) and Reg. § 1.512(b)-1(d)

- Generally, excluded, unless:
  - Stock in trade or inventory
  - Property held primarily for sale to customers in ordinary course of trade or business
  - To the extent the property is debt-financed

#### What are the special rules pertaining to Unrelated Debt-Financed Income (UDFI) and Acquisition Indebtedness?

- Section 514 does not apply to amounts which are otherwise included in the computation of UBTI – Reg. § 1.514(b)-1(b)(2)(ii)
- “Debt-financed property” – Section 514(b) and Reg. § 1.514(b)-1:
  - Any property held to produce income on which there is acquisition indebtedness at any time during the taxable year (or, if the property is disposed of during the taxable year, on which there was acquisition indebtedness at any time during the 12-month period ending with the date of disposition)
  - Does not include any property to the extent the income from it is included in computing the gross income of any unrelated trade or business (unless such income is excluded as gains or losses from sale or exchange under Section 512(b)(5))

## Section 2:

### How is UBTI calculated? (cont'd)

- “Acquisition indebtedness” – Section 514(c) and Reg. § 1.514(c)-1
  - With respect to debt-financed property, the unpaid amount of indebtedness incurred:
    - To acquire or improve the property
    - Before such acquisition or improvement, if such indebtedness would not have been incurred but for such acquisition or improvement
    - After such acquisition or improvement, if such indebtedness would not have been incurred but for such acquisition or improvement and which was foreseeable at such time
- Property acquired subject to a mortgage or similar lien
  - Amount of indebtedness secured by such mortgage or lien is considered indebtedness incurred in acquiring such property
  - Same effect where lien attaches to property for taxes or assessments under State law prior to time such taxes become due and payable, but only after such taxes or assessments become due and payable and entity had opportunity to pay the same
- **NOTE:** The term “acquisition indebtedness” does not include indebtedness incurred by certain qualified organizations (including qualified retirement plans, but not IRAs) in acquiring or improving any real property, but subject to numerous exceptions – Section 514(c)(9) and Reg. § 1.514(c)-2
- Computing UDFI – Section 514(a) and Reg. § 1.514(a)-1
  - Include in income that percentage (not greater than 100%) of the total gross income derived from debt-financed property during the taxable year determined as follows with respect to such property:
    - Average acquisition indebtedness
    - Average adjusted basis
  - Deduction allowed for proportionate amount of deductions directly connected with debt-financed property (except any depreciation to be computed on straight-line method)
  - “Average acquisition indebtedness” – Section 514(c)(7) and Reg. § 1.514(a)-1(a)(3)
    - Average amount of outstanding principal indebtedness during portion of taxable year that property is held
    - Computed as the sum of the outstanding principal indebtedness on the first day of each calendar month during taxable year that property held divided by total months (or portions thereof) that property is held during the taxable year
    - In computing percentage of any gain or loss on sale or other disposition of debt-financed property, must take into account highest amount of acquisition indebtedness on property during 12-month period ending with date of sale or disposition

## Section 2:

### How is UBTI calculated? (cont'd)

- "Average adjusted basis" – Reg. § 1.514(a)-1(a)(2)
  - Average amount of the adjusted basis of such property during portion of taxable year that it is held
  - Such amount is the average of:
    - Adjusted basis as of first day during taxable year that property is held
    - Adjusted basis as of last day during taxable year that property is held
  - Fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under Section 514(a)(2) does not affect amount of adjustment for depreciation used to determine average adjusted basis

## Section 3:

# Tax and Filing Form 990-T

## What tax rates apply?

- Corporate tax rates (under Section 11) – Section 511(a)(1) & (2)(A) seem to indicate that those rates apply with respect to qualified retirement plans; however, the instructions for Form 990-T (Line 36) indicate that they are taxed at trust rates
- Estate and trust tax rates (under Section 1(e)) apply with respect to any trust which but for its exemption from taxation under Section 501(a) would be subject to taxation under the trust rules – Section 511(b)
- Query – what rates apply to IRAs? Instructions for Form 990-T indicate that IRAs, SEPs, SIMPLEs, Roth IRAs, Coverdell IRAs (ESAs), and Archer MSAs are to be described as “Other trust” in Block G, thereby subject to tax at the less favorable trust rates
- If the IRA is eligible for the rates on net capital gains, Schedule D (Form 1041) is completed and the applicable tax is computed from the Schedule D (Form 1041) and reflected on the Form 990-T

## Requirements

- Fiduciaries of IRAs, SEPs, SIMPLEs, Roth IRAs, ESAs, MSAs and Qualified tuition programs that have \$1,000 or more of unrelated trade or business gross income must file Form 990-T – Reg. § 1.6012-3(a)(5)
  - The IRA owner is the fiduciary of his/her self-directed IRA and is the most likely person to have the information needed to determine if the UBIT applies and how it is to be computed
  - Most IRA agreements identify who has responsibility to compute UBTI and file any required Form 990-T
- IRAs invested in a RIC or a REIT may file Form 990-T to obtain a refund of income tax paid on undistributed long-term capital gains by following a specified procedure
- An IRA trust must enter its own Employer Identification Number (EIN) in Block D, not the IRA owner’s social security number or the EIN of the IRA trustee or custodian
- Must designate the applicable unrelated business activity code(s) that specifically describe the nature of the unrelated business activity in Block E of Form 990-T and must also describe the primary unrelated business activity in Block H
- Schedule C deals with rental income (from real property and personal property leased with real property)
- Schedule E deals with unrelated debt-financed income
- If gross income is \$10,000 or less, only need to complete a portion of Form 990-T and none of the schedules

## Filing – When and Where

- Qualified retirement plans and IRAs (including SEPs and SIMPLEs), Roth IRAs, ESAs, and MSAs have less time to file than other tax-exempt organizations
  - Day 15 of fourth month after end of tax year
  - Trusts may request automatic 3-month extension of time by using Form 8868, which may also be used to request an additional, but not automatic, 3-month extension

## Section 3:

### Tax and Filing Form 990-T (cont'd)

- Form 990-T is filed by mail or delivery to:

**Department of the Treasury  
Internal Revenue Service Center  
Ogden, UT 84201-0027**

### Paying the Tax

- Must pay any tax due in full by due date of return without extensions
- Electronic deposits we required using Electronic Federal Tax Payment System (EFTPS)
- Installment payments of estimated tax are required if UBIT is expected to be \$500 or more
  - Form 990-W (Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations) is used to compute estimated tax liability
  - Must take the alternative minimum tax in account, if applicable
- Interest and Penalties
  - If file a late return or fail to pay tax when due, interest and penalty charges may apply
  - Late filing penalty:
    - 5% of unpaid tax for each month or part of a month the return is late, up to 25% maximum
    - Minimum penalty for return more than 60 days late is lesser of tax due or \$100
    - Penalty waived if can show failure was due to reasonable cause
  - Late payment penalty:
    - ½ of 1% of unpaid tax each month or part of a month the tax is unpaid, up to 25% maximum
    - Penalty waived if can show failure was due to reasonable cause
- Estimated tax penalty – Form 2220 (Underpayment of Estimated Tax by Corporations) is used to determine if a penalty is owed and the amount



## Section 4:

### UBIT at the State Level

- No general rule, must consult tax laws of each State
- Rules for determining UBTI generally follow federal tax laws applicable to tax-exempt entities
- What controls: situs of IRA owner, situs of IRA trustee or custodian, or situs of property?
  - Generally, if income from unrelated trade or business derived from sources within the State, there may be a filing requirement (i.e., situs of property rule)
  - If income derived from sources outside the State, but the trustee or custodian is resident of the State, there may be a filing requirement
  - Many States that impose an UBIT apply some variation of the three-factor situsing apportionment formula based upon situs of income producing factors within the State as compared to their situs elsewhere: payroll, sales, and property
- IRAs seem to slip through cracks in some State laws where UBIT is imposed (NOTE: Tax agents or authorities not always in agreement as to application)
  - Tax imposed on trust income by reference to federal Form 1041, which IRAs do not file
  - However, if UBIT imposed by reference to Sections 511-514, then tax may apply
  - Certain States (e.g., Arizona, Colorado, Georgia, Minnesota, New York and Virginia) impose UBIT by reference to entities exempt from tax under Section 501 or listed in Sections 511(a)(2) & (b)(2), and although IRAs are subjected to the same tax as imposed by Section 511 (by reason of Section 408(e)(1)), IRAs are not listed in Sections 501 or 511
- Where States impose UBIT, some also have requirement to file and pay estimated taxes

## Section 5:

### UBIT and Multiple IRAs

Only one deduction under Section 512(b)(12) is allowed in computing an IRA's UBTI, regardless of the number of unrelated businesses in which it is engaged (See Rev. Rul. 68-536, 1968-2 C.B. 244). Yet, multiple IRAs can serve to minimize UBIT exposure. When utilizing multiple IRAs, each IRA may claim a separate specific deduction of \$1,000 when calculating the UBIT owed.

Additionally, an IRA with two or more investments with UBTI, the losses from one may offset the income of another when calculating UBIT, but UBTI from multiple IRAs cannot be combined.

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