INVESTOR'S GUIDE TO UNRELATED BUSINESS INCOME TAX for IRAs

IRAs may be subject to taxes, but only in certain circumstances.

New Direction TRUST COMPANY

UBIT

Introduction

UBIT (Unrelated Business Income Tax) is a cost of doing business for an IRA, HSA, or 401(k) when that account utilizes a few particular investment structures. Some investors are hesitant to invest in a manner that may incur UBIT because they see it as wrong or as a penalty. In reality, it's not prohibited, and it's not a penalty. That said, it is a tax that may affect your ROI. Therefore, it is important to know how UBIT works in order to choose your best investment strategy.

Defining Terms

- UBIT = Unrelated Business Income Tax. This tax may be triggered by UDFI or UBTI.
- UDFI = Unrelated Debt Financed Income.
- UBTI = Unrelated Business Taxable Income

An IRA May Need to Pay UBIT If

- During a tax year, the IRA makes a net profit from rental income on property that has outstanding debt. This is an instance of UDFI.
- The IRA makes a profit from the sale of a property that has outstanding debt in any of the 12 months prior to the date of sale. This is an instance of UDFI.)
- The IRA has ownership in an ongoing business that is not owned by a C-Corp (which would necessitate the payment of "business" tax). This is an instance of UBTI.

An IRA Does Not Need to Pay UBIT if it Earns Money From

- Dividends, interest, annuities and other investment income
- Income from lending securities
- Rents from or proceeds derived from sale of a property with no outstanding debt
- Royalties

UBIT is not a personal tax. It is paid by your IRA, and calculated on a Form 990-T which is a little like a 1040 for your IRA. Any UBIT due in a tax year does not affect your personal tax filing. In fact, when filing a 990-T, your IRA will have established its own tax ID number.

Things to Remember on UBIT Generated by UDFI

- For profit created by debt leverage on a property, the outstanding debt percentage is calculated by averaging the previous 12 full months' debt percentage
- The debt percentage at the time of sale of a property is considered to be the highest debt percentage in any of the 12 full months prior to the sale date
- Can do a 1031 exchange within IRA to defer UBIT from the sale of a property
- When calculating UBIT, the IRA can offset net profits in a year with losses claimed in earlier years
- Ongoing UDFI pays UBIT at Trust and Estate Rate
- UDFI incurred at sale of real estate is a combination of sec. 1250 gain and short or long term capital gains (depending on how long IRA owned property)

UBIT

Things to Remember on UBIT Generated by UBTI

- When calculating potential UBIT, the IRA can offset net profits in a year with losses claimed in earlier years
- Review your K-1 for possible UBTI
- “Fix-n-Flip” real estate income is generally considered to be operating income
- UBTI pays UBIT at Trust and Estate Rate

Consider These 7 ways to Lessen the Impact of UBIT or to Avoid it Altogether

1. Have your IRA buy real estate with 100% cash from the account. UBIT from debt is levied on UDFI, the net profit that corresponds to the outstanding debt-leveraged percentage. So, if there is no debt, there will be no UBIT calculation.
2. Solo 401(k)s generally do not have to pay UBIT from UDFI.
3. Partner instead of leverage. Partnering is a way to participate in an asset that costs more than your IRA has without using debt leverage. An IRA can partner with both disqualified and non-disqualified persons.
4. Use losses from previous years to offset profits in the current year. Losses from an IRA in a given year can be “banked” to use in later years to offset profits.
5. Pay down debt leverage. By decreasing the debt percentage, the overall tax paid by your IRA will be less. Keep in mind that your IRA can use earnings from its other investments to pay down this debt if desired.
6. Pay off debt leverage12 months prior to the sale of an IRA owned property. The percentage of debt leverage with which UDFI is calculated is the debt leverage percentage of the month that is the highest amongst the previous 12 months. So, if your IRA sells its property 12 full months after it has paid off its debt leverage, no UBIT will occur on sale profits.
7. When investing in an ongoing business, choose a C-Corp. If the corporate entity is paying “business” tax before profits are disbursed to investors (including IRA investors), then no UBIT from UBTI will occur.

Filing a 990-T

When your IRA needs to file a Form 990-T with the IRS, it is necessary to have a tax ID number for that specific IRA. The deadline for filing a 990-T is tax day. If your tax professional is unfamiliar with filing Form 990-T, our sister company, IRA Tax Services, is available to help. Their contact number is 303-604-6466.