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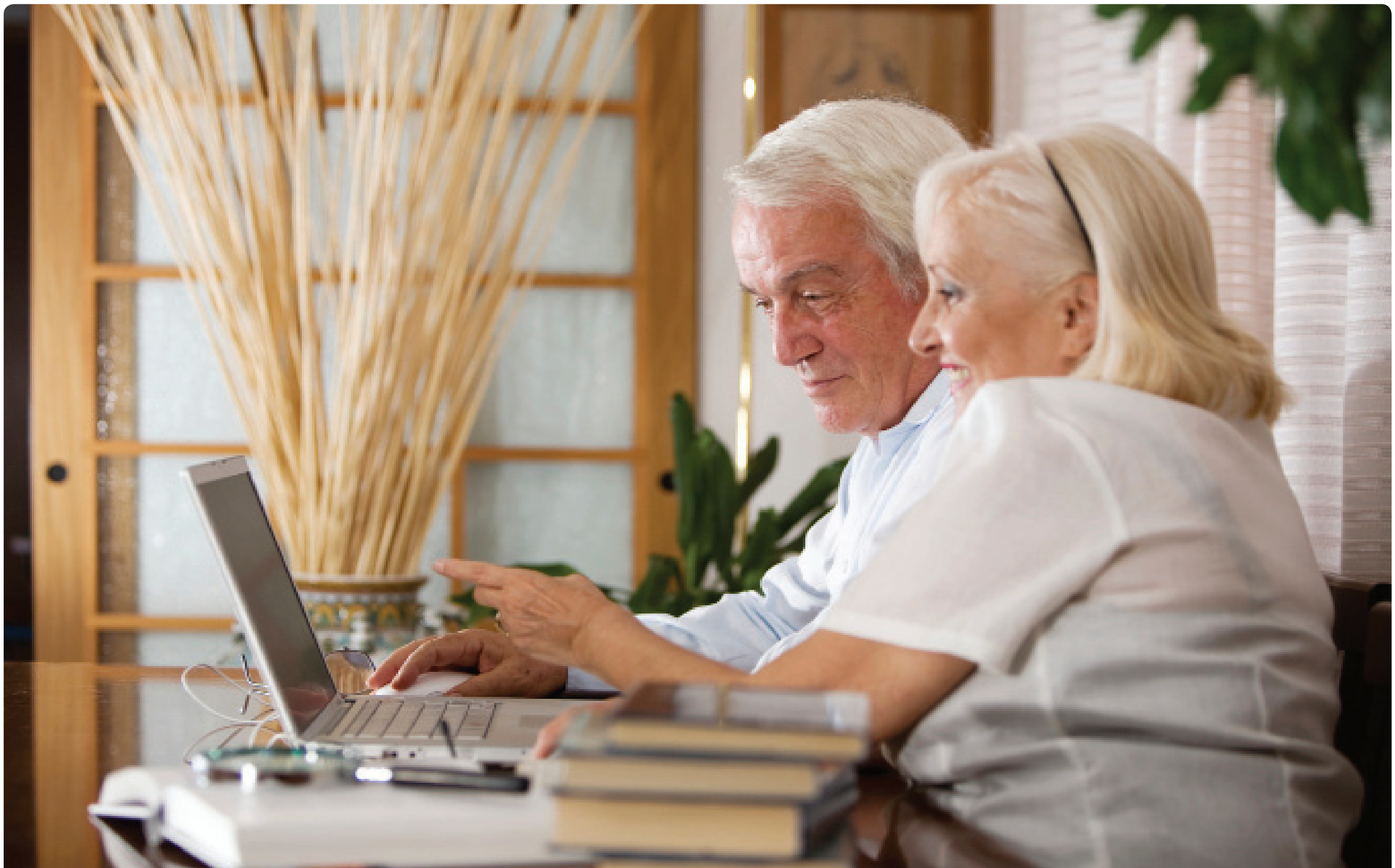

Understanding UBIT and UDFI

Unrelated Business Income Tax and Unrelated Debt-Financed Income

Entrust does not promote any investments. Rather, Entrust provides the administration, information, and tools to make self-direction straightforward and compliant. We help you get started quickly and stay with you every step of the way.

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UBIT and UDFI

Even though some retirement accounts are recognized as tax exempt, they still may be liable for tax on **unrelated business income**.

Unrelated business income is defined as income from a trade or business, regularly carried on (showing a frequency and continuity), that is not substantially related to the purpose of a retirement account. A retirement account is established for the exclusive benefit of the account holder and his/her beneficiaries.

An exempt account that has $1,000 or more of gross income from an unrelated business must file Form 990-T, the Exempt Organization Business Income Tax Return.

Example:

> Amy uses her Entrust self-directed Traditional IRA to form an LLC, Amy's Violins.
>
> The company refurbishes old violins and rents them out to students. Although Amy's IRA owns the LLC, the business being conducted is not for the exclusive benefit of the IRA, rather it is to benefit the LLC.
>
> Amy's Violins earned $64,000 in 2012. Amy's IRA would be subject to UBIT because the investment in the LLC earned over $1,000 and because the business does not relate to the purpose of the IRA.

Section 514 of the Internal Revenue Code expands unrelated business income to include **unrelated debt-financed income** from investment property. The investment income included is proportionate to the debt on the property. Various types of passive income are subject to this tax, but only if the income arises from property acquired or improved with borrowed funds, and the production of income is unrelated to the purpose constituting the basis of the tax exemption.

In calculating UDFI, one must also understand the concept of **acquisition indebtedness.**

For there to be acquisition indebtedness, there must be a debt. Acquisition indebtedness means the outstanding amount of:

1) the principal indebtedness incurred in acquiring or improving the property,
2) the principal indebtedness incurred before the acquisition or improvement of the property, if such indebtedness would not have been incurred but for such acquisition or improvement, and
3) the principal indebtedness incurred after the acquisition or improvement, if such indebtedness would not have been incurred but for such acquisition or improvement and such indebtedness was reasonably foreseeable when the property was acquired or improved.

The formula for deriving unrelated debt-financed income is:

Figure 1.0

$$\frac{\text{Average Acquisition Indebtedness}}{\text{Average Adjusted Basis}} \times \text{Gross Income} = \text{UDFI}$$

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Example:

John's self-directed Roth IRA owns an office building, which is debt-financed property. For 2012, the building produces $10,000 of gross rental income.

The average adjusted basis of the building for 2012 is $100,000, and the average acquisition indebtedness with respect to the building in 2012 is $50,000. Accordingly, the debt/basis percentage for 2012 is 50 percent.

Therefore, the unrelated debt-financed income with respect to the building for 2012 is $5,000. See below.

Figure 1.1

$$\frac{\$50{,}000}{\$100{,}000} \times \$10{,}000 = \$5{,}000$$

If an IRA needs to pay UBIT, trust tax rates are used rather than individual tax rates, because the IRA is a trust custodial account. Only amounts over $1,000 are considered in the calculating tax.

Figure 1.2

Trust Income	Trust Tax Rate
Not over $2,400	15% of taxable income
Over $2,400 but not over $5,600	$360 + 25% of the excess over $2,400
Over $5,600 but not over $8,500	$1,160 + 28% of the excess over $5,600
Over $8,500 but not over $11,650	$1,972 + 33% of the excess over $8,500
Over $11,650	$3,011.5 + 35% of the excess over $11,650

Using the example in *Figure 1.1*, the applicable tax can be calculated with the trust tax rate as follows:

Trust Income: $5,000

Trust Tax Rate: $360 + 25% of excess over $2,400

$5,000 - $2,400 = $2,600 *(excess)*

$2,600 x .25 = $650 *(25%)*

$360 + $650 = $1,010

The tax due for 2012 is **$1,010**.

Although UBIT is an additional tax that investors may not have anticipated, it does reflect the positive performance of asset. If an investor is responsible for paying UBIT, the asset must have earned at least $1,000 for the given year.

Here are some additional points to keep in mind in regards to UBIT.

- Net Operating Loss (NOL) rules apply as they normally would, and you can carry NOL back 2 years or forward up to 20 years. *See IRS Publication 536.*
- You can carry forward NOL to offset future UBIT.
- Capital loss rules apply as they normally would, and you can carry capital losses back three years or forward five years.
- You can carry forward capital losses to offset future capital gains.

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- All UBIT must be made out of the IRA account. You can transfer or rollover money from other retirement funds into the IRA to pay the tax, or make a contribution.
- Your IRA is required to file Form 990-T if the UBIT is over $1,000. Each IRA must file its own Form 990-T. If a single IRA has multiple UBIT generating activities, all taxes are reported on the same form.
- If your IRA is investing through a partnership or LLC, make sure that it is clear who is responsible for filing Form 990-T. Tax forms for the partnership or LLC do not replace Form 990-T.

The Entrust Group

With over 30 years of experience in the self-directed arena, Entrust understands the regulations, the investment options, and the value of personal service. We provide the administration, information, and tools to make self-direction straightforward and compliant.

We are committed to providing you with outstanding service. If you have questions on UBIT, UDFI, or self-direction, please contact us at any time.