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How to Compute Unrelated Debt Financing Income Tax (UDFI)

Unrelated Business Income Tax (UBIT)

Your Self-Directed IRA may borrow money to make an investment. However, the use of borrowed money can cause a taxable event if the investment earns a profit called Unrelated Debt Financing Income Tax (UDFI).

Before you decide that your IRA should use borrowed funds to make an investment, it’s a good idea to analyze the effect UDFI Tax will have on your IRA’s return. This report will help you estimate that tax before you act.

> Some people mistakenly refer to UDFI as Unrelated Business Income Tax (UBIT). However, UBIT is a different matter. The confusion is understandable as both UBIT and UDFI use the same IRS Form (Form 990-T) when filing the tax return.

Before we begin, let’s look at the advantages and disadvantages if you decide your IRA should use borrowed money to make investments.

Advantages of Your IRA Using Borrowed Money to Make an Investment	Disadvantages of Your IRA Using Borrowed Money to Make an Investment
1. It may help your IRA get an investment it would not have been able to previously afford without the debt.	1. Leverage increases risk. This is because the lender will want their (monthly) payments. There may be factors affecting your ability to keep up with these payments. For example: • If the property you're expecting to receive rent from has: o No tenant o A slow paying tenant • If you have a flip property you expected to sell quickly, but it takes longer than you originally anticipated to sell. 2. If your IRA uses borrowed funds to finance a purchase, you will have to complete (or hire a professional to complete) an IRS Form 990-T. 3. The IRA will be responsible for paying all income tax due from the use of leverage.

Well over 99% of IRA investments do not use borrowed money, hence, never file a 990-T or become subject to UDFI Tax. However, there are times when the owner of the IRA may decide that the use of borrowed money (by the IRA) might be advantageous.

The Basics of Having Your IRA Borrow Money to Make an Investment

The loan must be non-recourse.

Getting the Loan

The IRA obtains the loan on its own merits.
You, a family member, or a business controlled by you may not sign or countersign for the loan.

The IRA loan must come from a non-related third party such as a bank or a non-related individual or business (i.e., your mother may not loan the money to your IRA).

Repaying the Loan

The IRA must repay the loan. (You may not repay the loan for the IRA.)

If the IRA Defaults:

If the IRA defaults on the loan, the lender has no recourse against you or your IRA. The only collateral (security) the lender will have, is the asset your IRA pledged.

For example, let's say your IRA owns 5 houses:

- 4 of the houses are owned without debt.
- 1 house has a loan that is yet to be paid off. This one house is being used as the collateral for the loan.

If the IRA defaults on the loan, the lender can only "attach" the one property that was pledged as collateral. Not the entire IRA.

- The IRA account owner (you) or a family member may not loan money or assets to the IRA.
- The IRA account owner (you) or a family member may not sign / co-sign or countersign for the loan. (The loan is to the IRA and is referred to as a non-recourse loan.)
- The portion of the income earned by the IRA that is attributable to the borrowed money is taxable income to the IRA (UDFI Tax).
- Each year, if there is an outstanding loan for any part of the year, the IRA must file a tax return by using the IRS Form 990-T.

The following is intended to help you analyze the use of leverage. This sample is not a replacement for a complete computation required at tax filing time. UDFI Tax should be computed by a qualified tax professional.

How to Compute UDFI Tax

An IRA is a trust. This is a good thing as it substantially increases the separation between you and the asset (which is good for asset protection). This means when you invest with your IRA, you get the benefits of a revocable trust without the cost of drafting a trust.

However, given that an IRA is a trust, the IRA pays income tax at the trust tax rate.

Trust Tax Brackets – for 2017			
Taxable Income Over	Up To	The Tax is	Over the amount of
$0	$2,500	15%	$0
$2,500	$5,900	$375 + 25%	$2,500
$5,900	$9,050	$1,225 + 28%	$5,900
$9,050	$12,300	$2,107 + 33%	$9,050
$12,300	No limit	$3,179.50 + 39.6%	$12,300

Step 1

Computing UDFI Tax requires you know three numbers:

- The net income of the property for the period.
- The adjusted basis of the asset for the period.
- The average amount of the unpaid loan balance for the period.

How to:

<u>NET INCOME</u>: Establish the income earned by property for the period.

(We will start by assuming a rental property)

+ Rent Income
    - Management company fees
    - Maintenance and repairs
    - Insurance
    - Property Taxes
    - Mortgage interest
    - Legal and accounting (if any)

- <u>Any other costs the IRA paid to own the property</u>

= NET INCOME

<u>AVERAGE BASIS</u>: Establish the average basis in the asset for the period.

+ The Purchase Price
+ Closing and legal costs
+ Cost of improvements
- <u>Depreciation (generally use straight line 27.5 years) (330 months)</u>

= Adjusted Basis

Do the above computation for the beginning of the period and for the end of the period to obtain the Average Adjusted Basis.

<u>UNPAID BALANCE</u>: Establish the average balance due on the loan for the period.

Add the loan balance due on the first day of each month for the period.
Divide by the number of months.
= Average amount of the unpaid loan balance for the period (average debt).

Now that you have the three key numbers, from this point forward it's just simple math**:**

Step 2

$$\frac{\text{Average Unpaid Balance}}{\text{Adjusted Basis}} = \text{Leverage Ratio (to apply to Net Income)}$$

Step 3

Net Income X Leverage Ratio = Unrelated Debt Financing Income

Step 4

Enter "Unrelated Debt Financing Income" on page 1, line 7 of Form 990 T.
Go to Line 33 and deduct $1,000. In general, this will give you the "Taxable Amount".

Now, go to the "Trust Tax Bracket" chart to estimate the tax due.

Note:

1. Your IRA must pay the income tax (because your IRA made the money, not you)
2. Your IRA (not you) pays the professional you hire to complete the forms.

Client Service: If you do not want to complete Form 990-T yourself, the IRA Club can suggest tax professionals who specialize in the field.

Let's do two examples:

Example 1: **For a Property Earning Rental Income.**
(This is an abbreviated example; your actual computation will have more items.)

Assumptions:

- The IRA bought the property on 01/01/2016
- 36 months have past
- Today, we are working on our 2018 Income Tax

Net Income 2018

	Rent	$12,000
-	Maintenance	$1,800
-	Property Tax	$1,000
-	Insurance	$800
Net Income		$8,400

Basis (01/01/2016)

Acquisition Cost	$75,000
Closing Costs	$6,000
Improvements	$12,000
	$93,000

$93,000 was the basis at the time of acquisition. But what's the basis now?

$93,000 / 330 months = $281.81
(So, this property is depreciating at a rate of $281.81 a month)

Assume we are working on the 2018 taxes.
Basis on 01/01/2018: $93,000 - $6,764 = $86,236
(Reason: The depreciation rate is $281.84. Therefore, $281.81 X 24 Months = $6,764)

Basis on 12/31/2018: $93,000 - $10,145 = $82,855
(Reason: The depreciation rate is $281.84. Therefore, $281.81 X 36 Months = $10,145)

Average Basis for the period:

$86236 + $82855 / 2 = $ 84,545

Average Unpaid Balance

Unpaid balance on 01/01/18 = $52,000

Unpaid balance on 12/31/18 = $49,500

(You obtain this information from the statement you receive from the lender)

	01-01-2018	12-31-2018	Average
Net Income			$8,400
Average Basis	$86,236	$82,848	$84,542
Average Unpaid Balance	$52,000	$49,500	$50,750

Determine the Leverage Ratio

$50,750 / $84,542 = 60%

This means that 60% of the net income is attributable to the debt.

$8,400 X .60 = $5,040

$5,040 - $1,000 (the income exemption [See Line 33 of Form T-990]) = $4,040 Taxable Income.

Now just go to the Tax Bracket Chart to estimate the amount of tax due the IRS from your IRA. $375+$385 = $760 due to the IRS.

Example 2: **Buying and Selling the Property**.

(This is an abbreviated example; your actual computation will have more items)

Average Basis

Acquisition Cost	$75,000
Closing Costs	6,000
Improvements	12,000
	$93,000

Sale Price $118,000

-	Closing costs	5,000
-	Interest on loan	2,500
	Net proceeds	$110,500
	Profit	$17,500
	Held for 95 days	
	Adjustment for	
	L.T. Capital Gains	0
	Taxable income	$17,500

Refer to the Tax Bracket Chart to estimate the amount of tax due to the IRS from your IRA. $3,179.50 + $1,861.20 = $5,040.70 due to the IRS.

HINT: From a tax standpoint, there is a better way to flip this property.
- Hold the property for one year.
- Rent it to a nice rent paying tenant.
- Then, sell the property after a year.

The tax on UDFI tax would then benefit from the Capital Gains rate (20%).
$17,000 x 20% = $3,400 due the IRS from the sale.

(Of course, there would be interest costs to carry for the year and a separate tax computation for the rental income.)

Important: The above is a sample intended to help you estimate the income tax that could be due if you decide to proceed with this investment. Some steps have been left out to streamline the examples. Always consult a qualified tax professional to complete the Form 990-T for your IRA.

IRA Club Tip:

1. If your IRA pays 100% of the costs to acquire a property, there is no need to file the Form 990-T or for your IRA to pay the tax. (This is the most common transaction).

2. If your IRA partners with another IRA, individual, etc. to acquire a property, there is no need to file the Form 990-T or for your IRA to pay the tax.

3. The $1,000 UDFI Income Exemption applies to the IRA (not to the asset). Hence, if you had two properties (both purchased with leverage) and kept them as two separate IRAs, each IRA would benefit from having its own $1,000 Exemption.

4. You are not required to complete the entire Form 990-T; In most cases fill in only Schedule E of the 990-T (not to be confused with Schedule E of the Form 1040). Then go back and fill in Pages 1 & 2.

5. Hints about Form 990-T:
   Section B (on page 1) asks that you identify why the organization is exempt – check the box labeled 408 (e).
   Line G (on page 1), check the box labeled “Other Trust”

6. Hold the asset for one full year past the date of the last payment to the lender and the amount of UBIT tax will be $0.

For More Information call The IRA Club toll free 888-795-7950
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