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In this article, Karter explains how some types of income earned by self-directed IRAs can be currently taxed as unrelated business taxable income.

Much has been written in recent years about the increasing popularity of self-directed IRAs, which allow retirement investors the flexibility to invest in a broad array of investment alternatives not offered by most traditional brokerage firms. Whereas traditional retirement accounts typically limit investments to stocks, exchange-traded funds, mutual funds, and bonds — and may use the term "self-directed" to connote that the investor, as opposed to a manager, chooses from among them — a true self-directed IRA can participate in almost any type of alternative investment, such as private equity, private lending, precious minerals, collectibles, and cryptocurrency, to name a few examples.

For those considering this form of retirement investment, it is important to be aware of the pitfalls inherent in self-directed IRAs that can cause significant adverse consequences — ranging from penalties and excise taxes to outright disqualification — or to consult with an experienced financial and tax adviser who can advise on how to steer clear of them.

This article does not focus on the draconian consequences of participating in what is commonly known as a "prohibited transaction,"[1] but rather on a far more common occurrence in which a taxpayer expecting a tax deferral on investment income in the case of an IRA, or tax elimination in the case of a Roth IRA, is confronted with the possibility that some or all of the income earned from a self-directed IRA investment will instead be subject to an immediate tax in the year it is earned. That can occur because of the treatment of the income generated by the IRA as unrelated business taxable income. In turn, the treatment of income as UBTI can subject the IRA to an unrelated business income tax.[2]

Broadly speaking, IRAs are tax-exempt trust entities under section 408(a) of the Internal Revenue Code. Roth IRAs are also tax-exempt under section 408A. Generally, amounts held in a traditional IRA are not taxed until the account holder takes a distribution.[3] On the other hand, owners of Roth IRAs can make tax-free withdrawals. The tax-deferred or tax-free nature of these types of entities (or any tax-exempt entity for that matter) is predicated on the notion that the income they earn is in furtherance of the tax-exempt purpose of the entity. For an IRA or other retirement account, the tax-exempt purpose is saving for one's retirement.

Subject to numerous exceptions, qualified retirement plans, individual retirement accounts, charitable organizations, and other organizations that otherwise are exempt from U.S. federal income tax (collectively, exempt organizations) nonetheless may be subject to the unrelated business income tax on UBTI.[4] Generally, UBTI refers to the gross income derived by an EO from a trade or business that it regularly carries on, the

[1] *See* sections 408(e)(2) and 4975.

[2] Although the terms often are used interchangeably, UBTI describes a type of income taxable to retirement plans, whereas UBIT is the tax resulting therefrom.

[3] Distributions from a non-Roth IRA can be made at any time, although those withdrawn by someone under the age of 59½ may be subject to a 10 percent early withdrawal penalty. A non-Roth IRA account holder who reaches age 73 must take annual required minimum distributions, known as RMDs.

[4] Section 511(a)(1).

conduct of which is not substantially related to the exercise or performance of its exempt purpose or function, less allowable deductions directly connected with that trade or business.[5]

Although one might rationally argue that any sort of self-directed IRA investment in an alternative investment is intended to produce a favorable return that facilitates the growth of an account intended for retirement, Congress, the courts, and the IRS have taken a dim view of that rationale. That likely stems from Congress's goal of enacting the UBIT, first introduced in 1950,[6] to level the playing field for taxable businesses so that they could fairly compete with tax-exempt organizations in investing capital in various business activities.[7]

The UBIT accomplishes that by imposing a tax on exempt entities, including IRAs, that engage in what is considered to be a trade or business operated for profit that is not substantially related to the purposes behind the entity's tax-exempt status.[8] Thus, for example, if an IRA invests in a restaurant that generates income from sales to customers, that income is taxable as UBTI because operating the restaurant is considered to be engaging in commercial activity unrelated to the purpose of the tax-exempt entity.

The good news is that not all income types, even from a business unrelated to the IRA's exempt purpose, are taxed as UBTI. Under section 512(b), income from interest, dividends, royalties, rents, and gains from the sale of property (other than property held for sale to customers in the ordinary course of a trade or business or that would be includable in inventory) are excluded from UBTI. For example, a self-directed equity investment in a real estate partnership that spins off rents would generally exclude those rents from UBTI. Similarly, gain produced from a sale by the partnership of the real estate that passes through to IRA partners would also be excluded.

There are always exceptions to income exclusions, which is true in the case of UBTI. One important exception to this general rule of exclusion relates to what is known as unrelated debt-financed income (UDFI).[9] Debt-financed property generally is income-producing property, the use of which is not substantially related to the EO's tax-exempt purposes, and for which there is "acquisition indebtedness" at any time during the tax year (or if the property was disposed of during the tax year, the 12-month period ending with the disposition).[10]

UDFI is generated when a retirement plan (for example, an IRA) borrows money to acquire real estate. The term used in the IRC to describe this circumstance is "acquisition indebtedness."[11] Acquisition indebtedness includes debt incurred to acquire property, debt incurred before the acquisition of property if the debt would not have been incurred but for the acquisition, and debt incurred subsequent to the acquisition of property if the debt would not have been incurred but for the acquisition and, at the time of acquisition, the incurrence of debt was foreseeable.

Thus, under the definition of acquisition indebtedness, the real estate investment example mentioned above seems broad enough to include debt incurred not only in connection with the acquisition of land on which to build but also on the construction of improvements built on the land after acquisition.

Income on and gain from the disposition of debt-financed property is UBTI, at least in proportion to the percentage of debt financing. The portion of the income from debt-financed property attributable to acquisition indebtedness is equal to the ratio of the average outstanding principal amount of acquisition indebtedness to the average adjusted basis of the property for the year. For example, if a self-directed IRA investor invests in a real estate venture that is 75 percent debt-financed, an equivalent percentage of the profits from that venture allocable to that investor will be treated as UBTI.

It also does not appear to make any difference if the acquisition debt is borrowed directly by the

[5] Section 512(a)(1).

[6] Revenue Act of 1950.

[7] S. Rep. No. 81-2375, at 30 (1950); H.R. Rep. No. 81-2319, at 38 (1950). *See also* reg. section 1.513-1(b).

[8] Reg. section 1.513-1(d)(1).

[9] Section 514.

[10] Section 514(c).

[11] *Id.*

retirement plan investor or by a partnership in which that investor invests. A partner can have acquisition indebtedness from his share of the partnership's borrowing. Finally, although some types of retirement plans are excepted from these rules (that is, exceptions to exceptions to exclusions), these exceptions appear to apply only to "qualified organizations," which does not include IRAs.[12]

Whether an investment by a self-directed IRA through an interest in a partnership generates UBTI will be determined at the partnership level. Each year, the partnership generates a Schedule K-1 distributable to the investor partners. For those who have received a Schedule K-1 in the past from a partnership investment, whether you are a retirement investor or not, you might notice a legend explaining the potential inclusion of UBTI that resembles the following:

> Box 20 Code V — Unrelated Business Taxable Income (UBTI)
>
> For tax-exempt organizations only: Some tax-exempt organizations, including qualified pension, profit-sharing, and individual retirement accounts, may be subject to federal income tax on UBTI.
>
> Income/loss in box 1 of Schedule K-1 is UBTI because it is attributable to an active trade or business. The rules for unrelated business income are complex. Please consult your tax adviser.

If your investment did not generate any rental income or capital gains from a sale or partial sale, the legend may be on the Schedule K-1, but you would not see any allocation of UBTI.

A tax-exempt plan with UBTI must file Form 990-T, "Exempt Organization Business Income Tax Return," if it has gross income from an unrelated trade or business of $1,000 or more. For conventional retirement plans, Forms 990-T, when needed, typically are completed by IRA custodians, who also can calculate the tax due and even remit payment directly from the account holder's IRA. However, for self-directed IRAs, the burden of filing Form 990-T is on the IRA's owner, as the IRA custodian will not do so or report or pay UBIT to the IRS for your IRA. The reason for this distinction is that the IRA custodian will likely lack specific knowledge of the nature of a self-directed IRA investment, or whether it will produce UBTI, and often will not have surplus cash sitting in the custodial account that could be used to pay the tax.

Consider the case of a self-directed IRA investor who invests in a real estate partnership that uses nonrecourse debt financing to acquire property and build on it. Again, the potential effect of UBTI on a retirement account investor in a partnership asset held for investment would likely depend on the ratio of debt to total cost (that is, debt + equity) of the investment. For example, if the project is 75 percent debt-financed, a corresponding 75 percent of the income (after deductions) could be UDFI subject to tax. The custodian will likely require the IRA account holder to identify the nature of the self-directed investment and, even in the case of a partnership equity interest, perhaps request a copy of the operating agreement. What the custodian is unlikely to request is the type of detailed information about the partnership that would allow it to identify the UDFI percentage, or even that there is debt financing that will give rise to UBTI.

To buttress that point, self-directed IRA custodians typically do not require the account holder to provide them with Schedule K-1, even though an IRA taxpayer listed on the form is technically "managed" by the custodian. Therefore, the example of a Schedule K-1 UBTI notice shown above is intended to alert the IRA investor that this may be an issue the investor must investigate further. In fact, a Schedule K-1 that provides that notice will often not identify the amount of UBTI allocable to the investor.

Ultimately, it is the investor's responsibility to report the tax if it is due and to pay the tax. If nothing on Schedule K-1 provides guidance, the general partner or managing member of a partnership or limited liability company should be contacted to determine if there is a specific UBTI amount that should be identified under Code V, Box 20 on the Schedule K-1. That means, to file the form, the IRA owner will first have to

[12]Section 514(c)(9).

obtain a tax identification number from the IRS for the self-directed IRA.[13]

As the Schedule K-1 legend above cautions, the UBIT and UBTI rules are complex, and there remain some unknowns about whether they will apply in all circumstances, and to what extent. For that reason, it bears repeating that self-directed retirement investors should consult their own tax advisers regarding the UBTI ramifications and other tax aspects of these sorts of investments.

If a UBTI/UDFI tax is due, it must be paid with retirement account funds, not personal taxable funds.[14] Also, the tax rate to the IRA for any UBIT due may well be higher than the tax rate a non-retirement investor would pay for a similar investment outside their IRA. That is because IRAs generally are taxed at the same rate as trusts, which reach the top federal tax rate of 37 percent much more rapidly than the graduated rates applicable to individual taxpayers. However, an IRA subject to UBIT may still be able to take advantage, at least in part, of the 23.8 percent long-term capital gains tax rates on profits from gains subject to UDFI, as opposed to being subject to the higher ordinary income UBTI rate for items such as taxable rents or short-term capital gains.

The moral of the story when considering a self-directed IRA investment is to make sure you understand the nature of the investment and the rules likely to apply to determine whether it will be currently taxable. If you conclude that the investment remains worthwhile even if subject to UBIT, and it happens that the funds you have available to invest reside in your IRA, you can avoid an unhappy surprise that your investment return is not necessarily what you expected after taking UBIT into account.[15] ■

[13] After 2022, partnerships with IRA partners must include the IRA partner's employer identification number on Form 1065, "U.S. Return of Partnership Income," Schedule K-1 if the IRA partner is receiving an allocation of UBTI. Often, the custodian will offer to obtain the EIN on the IRA partner's behalf for a fee, although the IRS has made applying for one online a relatively simple process. *See* IRS, "Apply for an Employer Identification Number (EIN) Online."

[14] Section 408(e).

[15] Those interested in learning more about UBTI should review IRS Publication 598 (rev. Mar. 2021).