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How a Self Directed IRA can Borrow to make Larger Investments

(and the tax on Unrelated Debt Financing Income)

The most common way for an IRA to buy an asset is to pay cash. However, there may be times when an alternative method of payment is practical.

Example, possibly your IRA has ample funds to buy an asset however; you don't want to use all your IRA's cash at this time.

There are two alternatives you may use to help your IRA make an investment that costs more than your IRA has in investable capital.

1. **An IRA may Partner**: In this case the IRA and another party can "partner" to make an investment. If you would like information about Partnering your IRA to make an investment see the IRA Club web site and click on:
   - Information Center
   - Partnering

2. **An IRA may Borrow**: Another way for an IRA to make in investment that costs more than the IRA may have in liquid capital is IRA can borrow money.

This report is on the topic of IRA Borrowing.

Like all things financial; IRA borrowing has advantages and disadvantages and each IRA owner should weigh these before borrowing money.

Advantages:

- By using borrowed money your IRA can make investments that it otherwise could not have made.
- Your IRA becomes the sole owner of the asset.

Disadvantages:

- When an IRA account takes on debt; as with any investment (whether inside an IRA or not) the greater the debt burden the greater the risk.
- An IRA that is using debt financing may be required to file an annual Income Tax Return (IRS Form 990-T) and the IRA may be required to pay income tax on the portion of the earnings that are generated based on the amount borrowed.

Example: Assume your IRA is considering an investment in a rental property. The total cost of the investment will be $100,000. Your IRA has $70,000 of investable capital and will borrow the balance.

- Total cost $100,000
- Investable Capital $70,000
- Debt $30,000

A. In the above, the IRA account (not the individual who owns the IRA) borrows the needed funds ($30,000).

The IRA (not owner of the IRA) is responsible to repay the loan. (This is called a Non-Recourse loan as the lender has no recourse to the owner of the IRA in case of default.)

Additional notes:

- The owner of the IRA (and any other disqualified person) may *not* “sign”, “co-sign”, “counter-sign” or in any way become liable for the loan.
- Not all lenders are willing to make non-recourse loans.
- Generally non-recourse lenders will ask for a larger “down payment” to protect their position.

Taxation notes:

- In the above example, 70% of the cost of the investment was paid for by the IRA; thus 70% of the earnings receive IRA tax treatment (I.e. the earning are income tax deferred)
- However, 30% of the cost of the investment was not paid for with the IRA funds, (the borrowed money). Thus, 30% of the earnings DO NOT qualify for IRA tax treatment. These earnings are called “Unrelated Debt Financing Income” (UDFI).
- To compute UDFI you will complete an IRS Form 990-T. If a tax is due that tax will be paid by the IRA (not by you) as it was the IRA (not you) that received the earnings.
- What is the amount of the tax?
  Form 990-T is the tool that computes the amount of taxable income. Then refer to the tax bracket chart to determine the tax rate. As an IRA

is a Trust, you should refer to the “Trust” chart. Below is a sample of the Trust Tax Brackets for 2015:

2015 Estate and Trust Brackets	
Taxable Income Up to	Marginal Tax Rate
$2,500	15%
$5,900	25%
$9,050	28%
$12,300	33%
Over $12,301	39.6%

Summary:

Typically an IRA pays cash for the investments it makes. However, there may be situations where the IRA may find it advantageous to “Partner” or “Borrow” in order to complete a transaction. Partnering and Borrowing both add complexity to the transaction and this should be considered prior to making the investment.