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The article is provided as a courtesy to IRA Club clients who may be considering using borrowed funds inside their IRA. This information is presented only as a guide. Always consult an Income tax professional and a qualified attorney before making any investment or entering into any transaction.

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 in effect that UDFI Tax will have your IRA's return. This report will help you estimate that tax before you take action.

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.

<p style="text-align: center;">Advantages Of your IRA Using Borrowed Money to make an Investment</p>	<p style="text-align: center;">Disadvantages Of your IRA Using Borrowed Money to make an Investment</p>
<p>1. May help your IRA get into an investment it could not have been able to afford without the debt.</p>	<p>1. Leverage increases risk. This is because the lender will want their (monthly) payments</p> <ul style="list-style-type: none"> • If the property is earning rent or not. <ul style="list-style-type: none"> ○ No tenant ○ Slow paying tenant • If it's a flip property you expected to sell quickly however, it took longer than expected to sell. <p>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.</p> <p>3. The IRA will be responsible to pay all income tax due from the use of leverage.</p>

Well over 99% of IRA investment 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 Your IRA Borrowing Money to Make an Invest

The loan must be None Recourse.

Getting the Loan

The IRA obtains the loan on its own merits.

You (a family member or a business you control or a family member) 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) for the lender will have is the asset your IRA pledged.

Example: Let's say 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 Nonrecourse 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 increased the separation between you and the asset (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, as 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 from the property for the period.
- The adjust “basis” in the asset for the period.
- The “average” amount of the unpaid loan balance for the period.

How to:

NET INCOME: Establish the income earned by property for the period.

(We will start by assume a rental property)

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

- Any other costs the IRA paid to own the property
- = NET INCOME

AVERAGE BASIS: Establish the average “basis” in the asset for the period.

- + The Purchase Price
 - + Closing and legal costs
 - + Cost of improvements
 - Depreciation (generally use straight line 27.5 years) (330 months)
- = 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.

UNPAID BALANCE: 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 arithmetic:

Step 2

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

Step 3

$$\text{Net Income X Leverage Ratio} = \text{Unrelated Debt Financing Income}$$

Step 4

Enter “Unrelated Debt Financing Income” on line 7 of page one of Form 990-T.
Go to Line 33 and deduct \$1,000. In general, this will give you’re the “Taxable Amount”.

Now go to the “Trust Tax Bracket’ chart to estimate the tax due.

Note:

1. Your IRA (not you) must pay the Income tax.
(Because your IRA and not you made the money.)

2. Your IRA (not you) pay the pay 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 1-1-2016
- 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	<u>800</u>
Net Income	\$8,400

Basis (1/1/2016)

Acquisition Cost	\$75,000
Closing Costs	6,000
Improvements	<u>12,000</u>
	\$93,000

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

$$\$93,000 / 330 \text{ months} = \$281.81$$

(So, this property is depreciating at a rate of \$281.81 a month)

Assume we are working on the 2018 Taxes.

$$\text{Basis on 1/1/2018: } \$93,000 - \$6,764 = \$86,236$$

(Reason: The Depreciation rate is \$281.84. Hence, $\$281.81 \times 24 \text{ Months} = \$6,764$)

$$\text{Basis on 12/31/2018: } \$93,000 - \$10,145 = \$82,855$$

(Reason: The Depreciation rate is \$281.84. Hence, $\$281.81 \times 36 \text{ Months} = \$10,145$)

Average Basis for the period:

$$\frac{\$86,236 + \$82,855}{2} = \$84,545$$

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.)

	1-1-2018	12-31-2018	Average
Net Income			\$8,400
Average Basis	\$86,236	\$82,848	\$84,542
Average unpaid Bal	\$52,000	\$49,500	\$50,750

Determine the Leverage Ratio

$$\frac{\$50,750}{\$84,542} = 60\%$$

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

$$\$8,400 \times .60 = \$5,040$$

\$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 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	<u>12,000</u>
	\$93,000
Sale Price	\$118,000

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

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

HINT: From a tax stand point, there is a better way to “flip” this property.

- Hold the property for one year.
- Rent it to a nice rent paying tenant.
- Then after a year sell the property

The tax on UDFI tax would then benefit from the Capital Gains rate (20%).

$\$17,000 \times 20\% = \$3,400$ 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 cost 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 is 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 I & 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 "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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