Circumstances in Which an IRA May Owe Taxes[1]

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A. Introduction

Many people are surprised to learn that, as discussed below, there are 2 ways in which an IRA or 401(k) investment in an entity may cause the retirement plan to owe tax on its income or profits from that investment. This does not necessarily mean that you should not make an investment which subjects your retirement plan to taxation. It does mean that you must evaluate the return on the investment in light of the tax implications.

B. Unrelated Business Income (UBI)

The first situation in which a retirement plan might owe tax on its investment is if the entity invested in is non-taxable, such as a limited partnership or an LLC treated as a partnership for tax purposes, and the entity operates a business. Although investment in an entity which is formed for the purpose of capital investment, such as the purchase and holding of real estate, should not generate taxable income for the retirement plan (unless there is debt financing, as discussed below), any income from business operations would be considered Unrelated Business Income (UBI) for the plan. UBI is the income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose, with the exception that the organization uses the profits derived from this activity. Exclusions from UBI include dividends, interest, annuities and other investment income, royalties, rents from real property (but not personal property), income from certain types of research, and gains and losses from disposition of property (except property which is considered to be inventory).

> *Example.* Ira N. Vestor has a large rollover IRA from a former employer and wants to help out his friend, Will B. Richer, who is starting a new restaurant business. Will offers Ira a 25% ownership interest in his new business, Eat Richer Restaurants, LLC. Ira believes Will is going to be a huge success, and wants to grow his IRA. The LLC will be taxed as a partnership. Ira will not be paid and will have no part in the management or operation of the business. Because the LLC is taxed as a partnership, the IRA must pay taxes on its share (whether or not distributed) of the gross income of the partnership from

[1] See 26 USC 511-514. If the tax applies, the IRA must file IRS Form 990T. A chart showing the circumstances in which an IRA may owe a tax is attached to these notes as Appendix 1. For more information, Unrelated Business Taxable Income is covered in IRS Publication 598.

such unrelated trade or business less its share of the partnership deductions directly connected with such gross income.[2]

C. Unrelated Debt Financed Income (UDFI)[3]

A second situation in which a retirement plan may owe tax is when the plan or an entity invested in by the plan owns debt financed property. Anytime a retirement plan owns debt financed real estate (with a possible exception for 401(k) plans, discussed below), either directly or indirectly through a non-taxable entity, the income from that investment is taxable to the retirement plan as Unrelated Debt Financed Income (UDFI). The amount of income included is proportionate to the debt on the property. Your retirement plan is only taxed on the debt financed portion and not the entire amount of income.

Definition of "Debt Financed Property." In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an ***acquisition indebtedness*** at any time during the taxable year (or during the 12-month period before the date of the property's disposal if it was disposed of during the tax year). If your retirement plan invests in a non-taxable entity and that entity owns debt financed property, the income from that property is attributed to the retirement plan, whether or not the income is distributed.

Calculation of UDFI. For each debt-financed property, the Unrelated Debt Financed Income is a percentage of the total gross income derived during a tax year from the property. The formula is as follows:

$$\frac{\text{Average Acquisition Indebtedness}}{\text{Average Adjusted Basis}} \times \begin{array}{l}\text{Gross Income from}\\ \text{Debt-Financed Property}\end{array}$$

Once the gross UDFI is calculated as above, your retirement plan is entitled to most normal income tax deductions including expenses, straight line depreciation and similar items that are directly connected with income from the debt financed property, plus an automatic deduction of $1,000.

Capital Gains Income. The good news is that if there has been no debt owed on the property for at least 12 months prior to the sale, there is no tax on the capital gains. However, if a retirement plan or a non-taxable entity owned by the retirement plan sells or otherwise disposes of debt-financed property and there has been acquisition indebtedness owed within 12 months prior to the date of sale, the retirement plan must include in its taxable income a percentage of any gain or loss. The percentage is that of the ***highest*** acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition in relation to the property's average adjusted basis. The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses. This means that long term capital gains are taxed at a lower rate than short term capital gains.

[2] See 26 USC 512(c).

[3] The rules specifically relating to Unrelated Debt Financed Income are found in 26 USC 514.

Example. Ira N. Vestor wants to use his IRA to invest in a limited partnership, Pay or Go, L.P., which will purchase an apartment complex. The lender requires a 20% cash down payment, and will not permit subordinate financing. Because the property is 80% debt financed, Mr. Vestor's IRA will owe a tax on approximately 80% of its net profits from the limited partnership (the percentage subject to tax changes as the debt is paid down and the basis is adjusted). When the property sells, Mr. Vestor's IRA will have to pay capital gains tax on the debt financed portion of the profits. Only the profits from the rents or capital gains from the sale that are attributable to the debt financing are taxable to the IRA. For example, if the gain on the sale of the apartment complex is $100,000, and the highest acquisition indebtedness in the 12 months prior to the sale divided by the average adjusted basis is 75%, then $25,000 of the gain is tax deferred or tax free as is normal with IRA's, while the IRA would owe tax (not Mr. Vestor personally) on $75,000.

D. Exemption From Taxes on UDFI for 401(k) Plans

One piece of great news for those with self-directed 401(k) plans is that plans under §401 of the Internal Revenue Code (IRC) enjoy an exemption from the tax on UDFI in certain circumstances. This exception to the tax is found in IRC §514(c)(9), and applies only to "qualified organizations." Qualified organizations include certain educational organizations and their affiliated support organizations, a qualified pension plan (ie. a trust qualifying under IRC §401), and a title-holding company under IRC §501(c)(25), but only to the extent it is owned by other qualified organizations. IRAs are trusts created under IRC §408, not IRC §401, so the real estate exception to the UDFI tax does not apply to IRAs. The good news is that plans such as the Entrust Individual (k) Plan do qualify for this exception under the right circumstances.

There are six basic restrictions which must be met for the exemption from the UDFI tax to apply. They are:

1) **Fixed Price Restriction**. The price for the acquisition or improvement must be a fixed amount determined as of the date of the acquisition or the completion of the improvement.

2) **Participating Loan Restriction**. The amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, must not be dependent, in whole or in part, upon any revenue, income, or profits derived from such real property.

3) **Sale and Leaseback Restriction**. The real property must not at any time after the acquisition be leased by the qualified organization to the seller of the property or to certain related persons, with certain small leases disregarded.

4) **Disqualified Person Restriction**. For pension plans, the real property cannot be acquired from or leased to certain disqualified persons described in 4975(e)(2), with certain small leases disregarded.

5) **Seller Financing Restriction**. Neither the seller nor certain related disqualified persons may provide financing for the acquisition or improvement of the real property unless the financing is on commercially reasonable terms.

6) **Partnership Restrictions**. Partnerships must meet any one of three tests if the exemption from the tax on UDFI is to apply to the qualified organizations who are partners. First, all of the partners can be qualified organizations, provided none of the partners has any unrelated business income. Second, all allocations of tax items from the partnership to the qualified organizations can be "qualified allocations," which means that each qualified organization must be allocated the same distributive share of each item of income, gain, loss, deduction, credit and basis. These allocations may not vary while the qualified organization is a partner in the partnership, and must meet the requirement of having a "substantial economic effect." Third, and perhaps most commonly, the partnership must meet a complex test called the "Fractions Rule" (or the "Disproportionate Allocation Rule").

Even with the restrictions, there are circumstances where this exemption can work. For example, one client rolled over her IRA into a 401(k) plan she created for her home based interior decorator business. The 401(k) plan then purchased 2 apartment buildings with non-recourse seller financing (which was on commercially reasonable terms). Not only is the 401(k)'s rental income exempt from the tax on UDFI, but so will the capital gains be exempt. If there is a concern about asset protection, a title holding §501(c)(2) or §501(c)(25) corporation can be formed, and the exemption will still apply.

But the best news of all is that we now have the Roth 401(k). Starting in 2006, if your plan allows it, you can defer part of your salary into a Roth 401(k). For 2007, the maximum salary deferral into a Roth 401(k) plan is $15,500 ($20,500 if you are 50 or over). This doesn't include the profit sharing contribution of the plan which can be up to 25% of the wages or net income from self-employment. Although the salary deferrals are post tax (meaning you still have to pay income, social security and Medicare taxes on the amount deferred into the plan), qualified distributions from the account are tax free forever. Unlike the Roth IRA, there is no maximum income restriction. Combining the power of an Entrust self-directed Roth 401(k) and the real estate exception for 401(k) plans under IRC §514(c)(9) means you can use Other People's Money to purchase real estate and NEVER PAY TAXES on the income and capital gains!

E. Frequently Asked Questions on Unrelated Business Income Tax

Q. If the profits from an investment are taxable to an IRA, does that mean it is prohibited?

A. Absolutely not! There is nothing prohibited at all about making investments in your IRA which incur tax.

Q. But if an investment is taxable, why make it in the IRA?

A. That is a good question. To figure out if this makes sense, ask yourself the following key questions. First, does the return you expect from this investment even after paying the tax exceed the return you could achieve in other non-taxable investments within the IRA? For example, one client was able to grow her Roth IRA from $3,000 to over $33,000 using debt financed real estate in under 4 months *even after the IRA paid taxes on the gain!* Second, what plans do you have for re-investing the profits from the investment? If you re-invest your profits from an investment made outside of your IRA you pay taxes again on the profits from the next investment, and the one after that, etc. At least within the IRA you have the choice of making future investments which will be tax free or tax deferred, depending on the type of account you have. Third, what would you pay in taxes if you made the same investment outside of the IRA?[4] The "penalty" for making the investment inside your IRA, if any, is only the amount of tax your IRA would pay which exceeds what you would pay personally outside of your IRA. Unlike personal investments, the IRA owes tax only on the portion of the net income related to the debt, so depending on how heavily leveraged the property is the IRA may actually owe less tax than you would personally on the same investment.

Q. If the IRA pays a tax, and then it is distributed to me and taxed again, isn't that double taxation?

A. Yes, unless it is a qualified tax free distribution from a Roth IRA, a Health Savings Account (HSA) or a Coverdell Education Savings Account (ESA). The fact is that you still want your IRA to grow, and sometimes the best way to accomplish that goal is to make investment which will cause the IRA to pay taxes. Also, bear in mind that companies which are publicly traded also pay taxes before dividends are paid, and the value of the stock takes into consideration the profits after the payment of income taxes. In that sense, even stock and mutual funds are subject to "double taxation."

Q. If the IRA makes an investment subject to tax, who pays the tax?

A. The IRA must pay the tax.

Q. What form does the IRA file if it owes taxes?

A. IRS Form 990-T, Exempt Organization Business Income Tax Return.

Q. What is the tax rate that IRAs must pay?

[4] Truthfully, this is not a fair comparison at all, since by definition you would be spending after tax dollars to make the investment outside of the IRA. In other words, since you already had to pay taxes on the money you have outside of the IRA, you had to start with more money than your IRA to make the same investment. This is the reason that tax deferred or tax free IRA's are able to accumulate wealth so much faster.

A. The IRA is taxed at the rate for trusts. Refer to the instructions for IRS Form 990-T for current rates. For 2005, the marginal tax rate for ordinary income above $9,750 was 35%. Capital gain income is taxed according to the usual rules for short term and long term capital gains. Remember, in the case of UDFI the IRA only pays tax on the income attributable to the debt and not 100% of the income.

Q. Where can I find out more information?

A. Visit our website at www.EntrustTexas.com for more information. Also, Unrelated Business Taxable Income and Unrelated Debt Financed Income are covered in IRS Publication 598, which is freely available on the IRS website at www.irs.gov. The actual statutes may be found in Internal Revenue Code §511-514.

F. Solutions to the UBIT "Problem"

Is there any way to get around paying this tax? The short answer is yes. Investments can often be structured in such a way as to avoid taxation. Dividends, interest, investment income, royalties, rents from real property (but not personal property), and gains and losses from disposition of property (unless the property is debt financed or is considered "inventory") are all excluded from the calculation of taxable income to the retirement plan. Some examples of how you might structure a transaction in ways that are not taxable to the retirement plan include:

Example. Suppose in the Eat Richer Restaurants, LLC example above the LLC elected to be treated as a corporation instead of a partnership, or a C corporation was formed instead (IRA's may not own shares of an S corporation). Because the entity has already paid the tax, the dividend to the IRA would be tax free or tax deferred. This may not be acceptable to other shareholders, however.

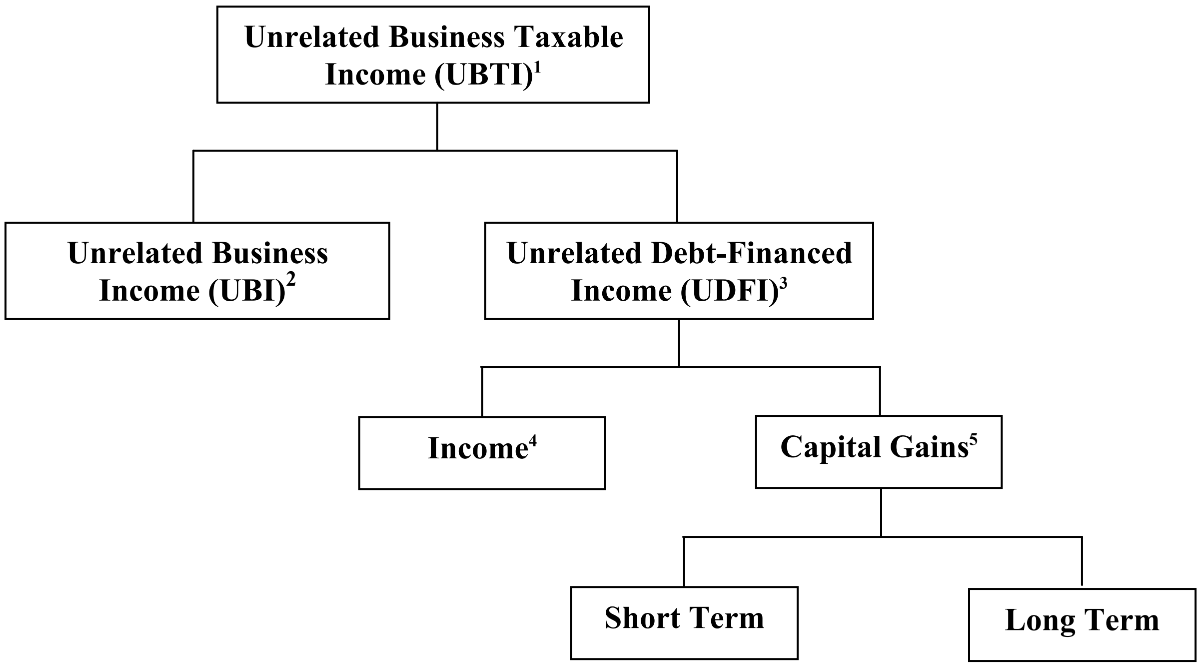
Example. Instead of his IRA directly in Pay or Go, LP, Ira N. Vestor could have made a loan instead. The loan could have been secured by a second lien on the property (which may not be permitted by the first lienholder, however). The loan could even be secured by shares of the LP itself, possibly with a feature allowing the loan to be converted at a later point to an equity position in the LP (a "convertible debenture"). *Caution:* With lending there may be state or federal usury limits on how much interest may be charged, and if the debt is converted into equity the IRA may then owe taxes at that time.

Example. Another choice for investing without the IRA paying taxes is to purchase an option instead. When your IRA owns an option to purchase anything, it can 1) let it lapse, 2) exercise the option, 3) sell or assign the option (provided the option agreement allows this) or 4) release the owner from the option for a fee (in other words, getting paid not to buy!).

G. Conclusion

A careful analysis of an investment which causes the IRA to owe tax will often lead to the conclusion that having your IRA pay taxes now may be the way to financial freedom in your retirement. Be sure to have your IRA pay the tax if it owes it, though.

Appendix 1



[1] UBI is generally taxable at corporate tax rates, except for exempt trusts described in Section 511(b)(2) (which includes IRA's, etc.), which are taxed at the tax rates for trusts. For 2004, the tax rate for trusts increased to the highest marginal tax rate (35%) at only $9,550 of UBTI.

[2] UBI is the income from a ***trade or business*** that is ***regularly carried on*** by an exempt organization and that is ***not substantially related*** to the performance by the organization of its exempt purpose, with the exception that the organization uses the profits derived from this activity. An organization may have UBI or loss as a member of a partnership rather than through direct business dealings with the public. If so, it must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. ***No distinction is made between limited and general partners***. Exclusions from UBI include ***dividends, interest, annuities and other investment income***, ***royalties***, ***rents from real property (but not personal property)***, ***income from certain types of research***, and ***gains and losses from disposition of property***.

[3] Investment income that would otherwise be excluded from an exempt organization's UBTI must be included to the extent it is derived from debt-financed property. **The amount of income included is proportionate to the debt on the property**. In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an ***acquisition indebtedness*** at any time during the taxable year (or during the 12-month period before the date of the property's disposal if it was disposed of during the tax year). For any debt-financed property, acquisition indebtedness is the unpaid amount of debt incurred by an organization 1) when acquiring or improving the property; 2) before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement; and 3) after acquiring or improving the property if (a) the debt would not have been incurred except for the acquisition or improvement and (b) incurring the debt was reasonably foreseeable when the property was acquired or improved.

[4] For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the same percentage as the average acquisition indebtedness with respect to the property for the tax year is of the property's average adjusted basis for the year (the debt/basis percentage). The formula is as follows:

$$\frac{\text{Average Acquisition Indebtedness}}{\text{Average Adjusted Basis}} \times \text{Gross Income from Debt-Financed Property}$$

[5]If an organization sells or otherwise disposes of debt-financed property, it must include, in computing UBTI, a percentage (not over 100%) of any gain or loss. The percentage is that of the ***highest*** acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition in relation to the property's average adjusted basis. ***The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses***. This means that short term capital gains are taxed at a higher rate as are other types of income, while long term capital gains are taxed at a much lower rate. Remember that in the case of UDFI, you are only taxed on the debt financed portion and not the entire amount of income.