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YOUR IRA ACCOUNTS CAN OWE TAXES

Most investors do not realize that an IRA account can owe taxes in certain situations. The four most common scenarios are when a retirement account does the following:

1. The IRA has borrowed money for an investment (mortgage loan on real estate). A percentage of the income will be subject to UBIT or UDFI.
2. The underlying investment is an operating (non-passive) entity that has pass thru income features like an LLC. The IRA would be responsible to pay the UBIT.
3. An investment in a passive LLC that has borrowed money. The income could be taxable because of the loan.
4. Rental of personal property

WHAT IS UBIT? Unrelated Business Income Tax is a tax that is levied on tax exempt entities such as retirement accounts. UBIT income is derived from a trade or business regularly carried out by the tax-exempt organization that is not substantially related to the exempt organization's exempt function.

The tax due for UBIT is reported on form 990-T, and the rates are based on the current Trust Tax Rates. These rates do accelerate faster than corporate and individual rates. The tax return only needs to be filed in years when there is tax due. The tax is calculated and paid annually. There is no tax on the first \$1,000 of net income.

HOW IS UBIT CALCULATED?

As I mentioned earlier, UBIT is only due on a percentage of the income generated from the asset. This percentage is calculated based on the average loan balance to cost percentage over the last 12 months. For example, if you have an interest only loan that was originally 60% loan to cost (LTC), after an income statement is prepared, 60% of the income would be subject to UBIT. Debt on IRA assets must be retired for 12 months prior to the sale of the IRA asset for UBIT to not apply. This is because the calculation is based on the prior 12 months average loan to cost percentage.

It is important to note with UBIT, the first \$1,000 of net income is exempt. Typically in an IRA, since you do not owe tax, you do not have a depreciation deduction. When calculating UBIT, the same LTV percentage can be used to deduct depreciation. All of the interest expense paid is deductible.

UBIT and UDFI are not all bad. The truth is for many investors, because of depreciation deduction and interest deduction, and the fact that the first \$1,000 of net income is not taxable, UBIT does not apply to every investor on a Real Estate IRA investment. Also, because of the loan, there is still the opportunity to do the deal in the IRA and hopefully make tax free gains. Remember, only a percentage of your income is subject to tax.

WHAT IS UNRELATED DEBT FINANCED INCOME TAX (UDFI)? UDFI is capital gains on the profits from the sale of real estate or other IRA assets. This tax is based on the current capital gains tax rate and filed on Form 990-T. **It is important to note that if you are going to buy another piece of real estate, you can do a 1031 exchange inside the IRA and avoid UDFI. This is easy and can be a huge savings for the IRA owner.

IRA TIP—Can you avoid UBIT and UDFI? There is a way to avoid the tax due. Individual K or Solo K plans are regulated by tax code section 401(k). Section 401(k) is more liberal than the IRA rules of section 408. 401(k) assets are not subject to pay UBIT or file a 990-T. If you are considering purchasing a piece of real estate with debt financing, an Indy K plan might save you a lot of extra work and money. The catch is not everyone qualifies to have an Indy K plan, so please check with your tax advisor to see if this type of plan works for you.

EXAMPLE: UBIT and UDFI (Buying Real Estate subject to a note and mortgage)

Bob Smith has a Self-Directed IRA with \$100,000 in cash. He would like to purchase a rental house for \$140,000 by making a down payment of \$70,000 and the seller will hold financing at an 8% interest only 30 year note on the difference. All loans in an IRA account must be nonrecourse. In this example, the portion of the income and expenses subject to UBIT will be 50% ($\$70,000 / \$140,000$) because UBIT is based on the average loan to cost over the prior 12 months. If the net rental income of the unit is \$5,000, 50% or \$2,500 will be subject to UBIT. After this number is calculated, the IRA owner can deduct all of the interest expense and 50% of the depreciation on the unit. This final net number is the amount that would be entered on the Form 990T. UBIT taxes are based on the trust tax rates. This calculation would have to be done annually. Continuing with this example—Lets assume Bob sells the house in 3 years for \$160,000 (a \$20,000 profit). In that year Bob will be subject to report his unrelated business income and his unrelated debt financed income (UDFI) (gain on sale). The UDFI is capital gains on the sale of the asset. If the debt to cost ratio is still 50%, \$10,000 ($\$20,000 \times 50\%$) would be subject to this capital gains tax. The 990T and the tax payment would be due May 15 of the following year.

Quote of Month

"Once you say you're going to settle for second, that's what happens to you in your life."

-John F Kennedy

Dave Owens, CPA, CES

Tax Free Strategies – Opportunities for the Savvy Investor

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Self-Directed Retirement Accounts

A self-directed IRA allows you to invest in both "traditional" investments such as stocks, bonds, and mutual funds, as well as "non-traditional" investments, like real estate, mortgages/deeds of trust, private placements, tax liens, and other private placements and limited partnerships. A self-directed IRA enables you to use your investment knowledge and expertise to manage your own investments. It is a common misconception that you can only hold CD's, stocks, bonds, and mutual funds in your IRA. This is simply not true. A self-directed IRA quite simply is an IRA account that allows you to directly manage and choose which investments to purchase.

There are so many options to consider with a self-directed IRA, listed below are the most popular investments

- Real Estates
- ⇒ Raw land
- ⇒ Rentals (Single Family/Duplex/Triplex)
- ⇒ Foreclosures
- ⇒ Short Sales
- ⇒ Condominiums/Commercial
- Notes/Mortgages
- Private Stocks
- Gold and other precious metals
- Private LLCs

- Structured Settlements
- Tax Liens/Certificates
- CDs/Stocks & Bonds
- Commodities/Futures/Forex
- & More

Why invest with your IRA Dollars—The main benefit of IRA investing vs After tax investing is the opportunity for tax free gains inside your account. By not having to pay the taxes on a sale of assets, you can keep more money for yourself to grow your nest egg and build wealth

How to set up a Self-Directed IRA?

The first step to get started in Self-Direction is finding the right IRA Administrator. Entrust is one of the top IRA Administrators in the United States. Entrust focus on helping IRA investors take control and purchase the assets they want. Entrust Freedom can be reached at 239-333-1031 or go to www.entrustfreedom.com.

Once you have identified your administrator, you will need to open an account and transfer funds from an existing IRA or make a contribution. Now that the account is set up, you will direct your administrator on what type of non-traditional asset you would like to purchase. Self Direction is easy, so why not take control today.

REAL ESTATE IRAS

If you've got an urge to sock away something in your IRA besides stocks, bonds and mutual funds, you may want to consider real estate. Raw land, houses, condos, commercial properties and even mortgage notes -- you can use an IRA to broaden your portfolio. A real estate IRA can be a great investment and offer a tremendous opportunity to investors who want to control and grow their IRA. Now maybe the time to take advantage of the record low prices in the real estate market and use your IRA to get started investing today.

FREE eBook ON REAL ESTATE IRAS

If you are looking to get started in Real Estate IRAs look no further than the eBook *Understanding Real Estate IRAs* written by Dave Owens CPA. The free download of this book can be found at www.daveowens.com. The book is a hands on guide to the ins and out of real estate IRA investing.

1031 EXCHANGES—WHAT IS A "QUALIFIED INTERMEDIARY"?

In a 1031 exchange, an investor must do more than sell real estate and reinvest the proceeds. To qualify for the favorable tax treatment the investor can't touch the proceeds from the sale. This is where a "qualified intermediary" or man-in-the-middle comes in. The investor hires an intermediary to handle the money in the 1031 exchange account until the investor is ready to close on a new property, which consummates the 1031 exchange. The QI's role also includes facilitating the exchange using an exchange agreement which means the QI becomes a party to the transaction. Based on the above description of the "qualified intermediary's" role, you can appreciate why it is important to choose an intermediary carefully. Choose an experienced Qualified Intermediary.

- How many years has your Qualified Intermediary been in business?
- How many exchanges have they performed
- Is the Qualified Intermediary Insured?
- Where are the proceeds kept during the holding period?

1031 Tax Free Strategies has been performing 1031 Exchanges since 1997. Trust an experienced Qualified Intermediary to help you make sure your exchange is handled with the highest degree of professionalism. For more info go to www.1031company.com or call 239-333-1031