Computing Tax on Unrelated Debt Financed Income (UDFI)

Your Self-Directed IRA may borrow money for 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 for an investment, it's a good idea to analyze the effect the tax will have on your IRA's return. This report will help you estimate that tax before you act.

Some people mistakenly refer to UDFI as Unrelated Business Income Tax (UBIT). Although UDFI is a subset of UBTI (unrelated business taxable income), it's important to note that UDFI is the income generated while the tax on the income is UBIT.

UDFI = Income
UBTI = Income
UBIT = Tax

Before we begin, let's look at the advantages and disadvantages if you decide your IRA should use borrowed money to make investments.

Disclaimer: 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 any transaction.

Unrelated Debt Financed Income (UDFI)

Quick Definition:

UDFI stands for **Unrelated Debt-Financed Income**, which is a tax that comes from a retirement account using debt-financing for its investments and is typically incurred in real estate. UDFI is calculated based on the percentage of the property that is financed with debt. This applies to both rental income and sale of property.

Should my IRA borrow money for an investment?

Advantages of your IRA using borrowed money for an investment	Disadvantages of your IRA using borrowed money for an investment
1. It may help your IRA get an investment it would not have been able to previously afford without the debt.	1. Leverage increases risk. This is because the lender will want their (monthly) payments. There may be factors affecting your ability to keep up with these payments. • For example: ○ If the property you're expecting to receive rent from has: ○ No tenant ○ A slow paying tenant • If you have a flip property you expected to sell quickly, but it takes longer than you originally anticipated to sell. 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. 3. The IRA will be responsible for paying all income tax due from the use of leverage.

Well over 99% of IRA investments 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 Having Your IRA Borrow Money for an Investment

The only loan an IRA can receive is a non-recourse loan.

Quick Definition:

A non-recourse loan is one in which the IRA account holder is not personally liable for the repayment of the loan. The non-recourse lender cannot pursue other assets owned by the account holder or the IRA. The IRA must repay the loan. You may not repay the loan for the IRA.

How does your IRA obtain a non-recourse 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). Some banks can include, but not limited to:

- First Western Federal
- North American Savings Bank
- Red Rock Capital
- Peak Asset Lending

IRA Club has no affiliation with any lender and earns no commission, fees, or other payments. You may contact these or other lenders when seeking leverage for your IRA project. Ensure you are performing due diligence to the best of your ability for any services, investments, or persons that involve your IRA.

Getting the loan

The IRA obtains the loan on its own merits. You, a family member, or a business controlled by you may not sign or countersign for the loan.

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) the lender will have, is the asset your IRA pledged...

For example, let's say your 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.

Here are the facts

- 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 non-recourse loan.)
- The portion of the income earned by the IRA that is attributable to the borrowed money is taxable income (UDFI) to the IRA. That tax is called UBIT.
- 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.

How to Compute Tax on Unrelated Debt-Finance Income (UDFI)

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.

An IRA is a trust. This is a good thing as it substantially increases the separation between you and the asset (which is 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, given that an IRA is a trust, the IRA pays income tax at the trust tax rate.

Trust Tax Brackets for 2025

Taxable Income Range	Tax Rate
$0 - $3,150	10%
$3,150 - $11,450	$315 + 24%
$11,450 - $15,650	$2,307 + 35%
$15,650+	$3,777 + 37%

Step 1: Computing tax on UDFI requires you know three numbers:

- The **net income** of the property for the period.
- The **adjusted basis** of the asset for the period.
- The average amount of the unpaid loan balance for the period.

Net income = Total income - expenses and fees

Expenses and fees can look like:

- 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

Adjusted basis = Purchase price + closing, legal & improvement costs - Depreciation

Depreciation (generally use straight line 27.5 years) (330 months)

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 = Add the monthly loan balance due / 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, it's just simple math:

Step 2

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

Step 3

Net Income X Leverage Ratio = Unrelated Debt Financing Income

Step 4

Enter "Unrelated Debt Financing Income" on page 1, line 7 of Form 990 T. Go to Line 33 and deduct $1,000. In general, this will give you the "Taxable Amount".

Now, go to the "Trust Tax Bracket" chart to estimate the tax due.

Note:

1. Your IRA must pay the income tax (because your IRA made the money, not you)
2. Your IRA (not you) pays the 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.

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 01/01/2024
- 36 months have past
- Today, we are working on our 2024 Income Tax

Net Income 2024

Rent	$12,000
- Maintenance	$1,800
- Property Tax	$1,000
- Insurance	$800
Net Income	$8,400

Basis

Acquisition cost	$75,000
- Closing cost	$6,000
- Improvements	$12,000
	$93,000

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

$93,000 / 330 months = $281.81

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

Assume we are working on the 2024 taxes.

Basis on 01/01/2024: $93,000 - $6,764 = **$86,236**

(Reason: The depreciation rate is $281.84. Therefore, $281.81 X 24 Months = **$6,764**

Basis on 12/31/2024: $93,000 - $10,145 = **$82,855**

(Reason: The depreciation rate is $281.84. Therefore, $281.81 X 36 Months = $10,145)

Average Basis for the period:

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

Average Unpaid Balance Unpaid balance on 01/01/24 = **$52,000**

Unpaid balance on 12/31/24 = **$49,500**
(You obtain this information from the statement you receive from the lender)

	01/01/2024	12/31/2024	Average
Net Income			**$8,400**
Avg. Basis	**$86,236**	**$82,855**	**$84,545**
Avg. Unpaid Balance	**$52,000**	**$49,500**	**$50,750**

Determine the Leverage Ratio

$$\frac{\$50,750}{\$84,545} = 60\%$$

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

$8,400 X .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. $275+$309.6 = **$584.6** due to the 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 cost	$6,000
- Improvements	$12,000
	$93,000
Sale Price	**$118,000**
- Closing costs	5,000
- Interest on loan	2,500
Net proceeds	**$110,500**
Profit	$17,500
Held for 95 days Adjustment for L.T. Capital Gains	0
Taxable income	**$17,500**

Refer to the Tax Bracket Chart to estimate the amount of tax due to the IRS from your IRA. $3,179.50 + $2,959.20 = **$5,238.70** due to the IRS.

HINT: From a tax standpoint, there is a better way to flip this property.

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

The tax on UDFI would then benefit from the Capital Gains rate **(20%).**
$17,000 x 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.

- If your IRA pays 100% of the costs 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).
- 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.
- 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 as two separate IRAs, each IRA would benefit from having its own $1,000 Exemption.
- 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 1 & 2.
- 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 labeled "Other Trust"
- 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.