Beware Unintended Tax Consequences of Unrelated Business Income

By Adam Bergman

In a number of instances, a mysterious tax known as UBIT or UBTI, or the Unrelated Business Taxable Income tax could be triggered and could cause financial havoc and turn a potential tax-free investment into a very tax-inefficient investment. The terms UBIT and UBTI refer to the Unrelated Business Taxable Income tax rules found in Internal Revenue Code Section 512, and I will be using the term interchangeably.

For nearly all retirement investors, when it comes to using a retirement account to make investments, most investments are exempt from federal income tax. This is because IRA and 401(k) plans are exempt from tax pursuant to Internal Revenue Code 408, and Section 512 of the Internal Revenue Codes exempts most forms of investment income generated by a retirement account from taxation. Exempt types of income include: interest from loans, dividends, annuities, royalties, most rentals from real estate, and gains/losses from the sale of company stock or real estate.

Income and gains from the sale of public company stocks, mutual funds, and exchange traded funds (ETFs) will not trigger the UBTI tax, which would exempt almost all retirement account investors from this tax. This is the reason why the majority of Americans have never heard of anything called UBTI or UBIT, and for all intents and purposes should not be overly concerned about these rules. However, for any retirement account investor who is investing or thinking about investing in real estate, using leverage (a loan) in a transaction, or investing in a private business operated through a pass-through entity, it’s time to acquaint yourself with the UBTI/UBIT rules.

In the 1950s the IRS, enacted a set of rules in order to prevent charities, and later retirement accounts, from engaging in an active trade or business and, thus, having an unfair advantage because of their tax-exempt status. These rules can be found under Internal Revenue Code Sections 511-514 and have become known as the Unrelated Business Taxable

Income rules or UBTI/UBIT. If the UBTI rules are triggered, the income generated from that activities will generally be subject to a tax of nearly 40% for 2015.

For a retirement account, like an IRA or 401(k) plan, UBTI generally applies to the taxable income of “any unrelated trade or business…regularly carried on” by an organization subject to the tax. The regulations separately treat three aspects of the quoted words: “trade or business,” “regularly carried on,” and “unrelated.” In other words, the retirement account’s investment must rise to the level of a trade or business, which is regularly carried on and is unrelated to its exempt purpose.

Unlike a charity, like the Red Cross, a retirement account does not have a specific exempt purpose, so the two factors that must be examined as to whether a retirement account has potentially triggered the UBTI rules is whether the activity rises to the level of a trade or business and whether it is regularly carried on. Unfortunately, the IRS has only offered limited guidance on these factors. It really comes down to the fact and circumstances involved in the transaction. However, here are a few examples of transactions that the IRS could view as rising to the level of an active trade or business and regularly carried on, thus, triggering the UBTI/UBIT rules:

• Developing or subdividing land and selling a large number of homes or tracts of land from that development in a given period

• Buying and selling a significant number of real estate properties in a year

• Making hundreds of private loans in a given year

• Business income from the operations of an active trade or business – e.g., a restaurant, gas station, store, etc. that is operated through a pass-through entity, such as an LLC or partnership. Note: income from a “C” Corporation, which makes up almost 99% of all public companies, such as Apple, Google, IBM, etc., blocks the application of the UBTI tax, which is why most Americans are not impacted by this tax.

• Using a nonrecourse loan (a loan not personally guaranteed by the retirement account holder) to purchase a property. Note: this is only applicable for an IRA as there is an exception under Internal Revenue Code Section 514(d) that exempts a 401(k) plan under certain circumstances from the UBTI tax for using a nonrecourse loan to buy real estate

• Using margin on a stock purchase

As the taxpayer, the retirement account holder would have the burden of proof to show the IRS that the retirement account investment activity did not rise to the level of an active trade or business and is not regularly carried on. Below are a number of factors that the IRS would likely examine in making their determination:

• The frequency of the transactions - how many transactions are done in a year

• The intent of the retirement account investor - was the person intending to engage in an active trade or business

• The scope of other activities of the retirement account to determine whether the activity is part of a business activity or an investment

• The personal investment and business activities of the retirement account holder and whether it is related to the retirement account investment at issue

• The time between the purchase and sale of the retirement asset

• The level of improvements made to the retirement account asset. For example, building a number of homes on raw land purchased as an investment can look more like a business than holding raw land

Just to be crystal clear, if all your retirement funds are simply buying traditional equities, mutual funds, and ETFs you will not have to worry much about the UBTI/UBIT tax rules. Interestingly, Blackstone Group (BX), which is listed on the New York Stock Exchange, is one of the only listed companies that is not a “C” Corporation. Blackstone is organized as a partnership so any retirement account investing in Blackstone would have to be aware of the UBTI/UBIT tax rules. Blackstone makes this clear in their 10-K filing with the SEC.

For any retirement investor looking to make alternative asset investments, it is wise to review the potential application of the UBTI/UBIT rules because of the high tax involved when the rules are triggered. The maximum tax rate of 39.6% is triggered at just $12,300. However, the UBTI/UBIT tax rules are not triggered if less than $1,000 of income is generated by the investment at issue. For retirement accounts, the UBTI/UBIT income is reported on IRS Form 990-T and the tax is is due by April 15. The tax would be paid by the retirement account.

Although the impact of the UBTI/UBIT rules may be limited to a small number of retirement investors making alternative asset investments, its impact can be substantial and could easily turn an attractive tax-free retirement investment into a very tax unfriendly one.