MassMutual

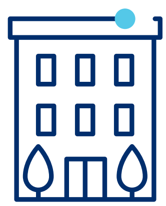
STRATEGY SPOTLIGHT*

Did I Just Make my IRA Taxable?

When you think of a traditional individual retirement account (IRA), you think of the ability to defer income taxes until retirement. What if you found out that an investment in your IRA could cause the IRA to owe income taxes every year on income earned in the account, even if you do not withdraw any money? You'd be surprised and none too pleased. How could this happen?

KEY POINTS

A self-directed IRA allows investment of retirement funds in alternative investments.



Certain alternative investments, such as an interest in a trade or business, can trigger income tax in a self-directed IRA.

If there is a tax that is due, it is levied on the self-directed IRA, not the IRA owner. Often this means that it is taxed at a higher rate.

Unlike an IRA that limits holdings to stock, bonds, mutual funds, annuities, or CDs, a self-directed IRA allows investors to invest retirement funds in "alternative investments" such as real estate, private mortgages, private company stock, LLC interests, and oil and gas limited partnerships, to name a few. Most traditional IRA custodians do not allow these alternative investments in their IRA accounts due to increased asset volatility, larger account fees due to the complexity of monitoring the underlying assets, and a higher chance of principal loss.

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The potential for taxation arises when investments in certain assets held in this type of IRA generate profits, resulting in Unrelated Business Taxable Income (UBTI), subject to the Unrelated Business Income Tax (UBIT). One of the assets most likely to trigger the UBIT is an interest in a trade or business. If the trade or business is structured as a pass-through entity, passing on income to investors (including the self-directed IRA) can trigger the UBIT. Another asset that may cause tax when owned this way is debt-financed property such as real estate subject to a mortgage.

If tax is due, it is levied on the self-directed IRA, not the IRA owner. The taxable income will be taxed at trust tax rates (37 percent on all income over $15,650 in 2025). Often the trust tax rates are higher than the IRA owner's personal tax rate.

Example

George decides to purchase a 10% interest in an LLC taxed as a partnership, using $200,000 from his self-directed IRA. In the first year, the business far exceeds George's expectations, and the share of the LLC's ordinary business income allocated to George's self-directed IRA is $100,000.

Because the $100,000 taxable income is passed directly to the self-directed IRA as its share of the partnership income, the IRA will owe UBIT of $35,035.50 — which is a large and unexpected tax bill. The custodian of the self-directed IRA will receive a Form 990-T, and the tax due must be paid from funds in the self-directed IRA, not George's personal assets. This reduces the IRA funds available for future tax-deferred growth.

When considering what assets to place into your self-directed IRA, consider the type of assets and the impact that UBIT may play at the end of the tax year. Holding an investment that could produce UBIT in a self-directed IRA may not be the best strategy. The full tax impact of a decision would require consultation with a tax advisor.

Additional Resources

Unrelated Business Income Tax

Unrelated Business Taxable Income