PASSIVE INVESTING SERIES

The Passive Investor's *Guide to UDFI* in Your IRA

What every self-directed investor should know before sending retirement dollars into a leveraged deal.

WHAT'S INSIDE

- Why an IRA pays no tax — and where that stops
- How Section 514 taxes the leveraged share of your return
- What happens to your gain at sale
- Which real estate investments avoid the issue entirely
- Questions to ask a sponsor before you subscribe

Written for investors who think carefully before they commit.

A Note to the Reader

Most investors are told that money inside an IRA grows without tax. For stocks and bonds, that is essentially true. For leveraged real estate, it is not — and the difference is large enough to change whether an investment makes sense at all.

Section 514 of the Internal Revenue Code removes the tax exemption from the portion of income a retirement account earns using borrowed money. It is called Unrelated Debt-Financed Income, or UDFI. It applies to traditional IRAs and Roth IRAs on identical terms. It applies whether you are an operator or an entirely passive limited partner. And because nearly every multifamily syndication carries a mortgage, it applies to most of them.

This is not an obscure trap. It is settled, decades-old law. But it is routinely left out of offering documents, and many investors first hear of it when a Form 990-T arrives in year two and their custodian asks them to fund a tax payment from an account with no cash in it.

We would rather you hear it from us before you subscribe than from your accountant afterward. Nothing here is a reason to avoid real estate. It is a reason to think carefully about which pocket you buy it with.

> *"The most expensive tax is the one nobody told you about until after you had already committed the capital."*

This guide covers six core areas:

- Why an IRA pays no tax — and where that stops
- How Section 514 taxes the leveraged share of your return
- What happens to your gain at sale
- Which real estate investments avoid the issue entirely
- Questions to ask a sponsor before you subscribe

CHAPTER 1

Why Your IRA Usually Pays No Tax

The general rule — and the boundary of it

A retirement account is a tax-exempt entity. Under Section 512(b), the categories of income it earns passively are specifically excluded from taxation while inside the account.

Income type	Treatment inside an IRA
Interest	Excluded — no tax
Dividends	Excluded — no tax
Rents from real property	Excluded — no tax
Royalties	Excluded — no tax
Capital gains	Excluded — no tax

This is the exemption every investor is relying on. It is real and it is broad. Note in particular that rent from real property is on the list: an IRA that owns an apartment building free and clear and collects rent generally owes no federal income tax on that rent.

The exemption is about the income, not the account

Congress exempted certain **kinds of income** — not everything an account happens to earn. Income falling outside those categories, such as income from an active trade or business, is taxable to the account as Unrelated Business Taxable Income, or UBTI, under Sections 511 through 513.

UDFI is a specific species of UBTI. It is the one that catches real estate investors, and it is the subject of the rest of this guide.

CHAPTER 2

The Exception: Section 514

Why leverage changes the answer

Section 514 answers a question Congress asked in the 1950s and 1960s: if a tax-exempt entity can borrow money and compound the returns tax-free, what stops it from borrowing indefinitely and outcompeting every taxable investor in the market?

The answer was to withdraw the exemption from the leveraged portion. If property is acquired with debt, the share of income attributable to that debt is pulled back into taxation — even though the identical income would have been exempt had the property been bought for cash.

> *The rule in one sentence: to the extent a tax-exempt account's property was bought with borrowed money, the income from that property loses its exemption.*

Three points that surprise people

It is the property's debt, not yours

You do not have to borrow anything. If you are a limited partner and the partnership carries a mortgage, your proportionate share of that debt is attributed to your account. Being entirely passive does not help.

Roth and traditional are treated identically

There is no Roth exception. A Roth IRA pays UDFI tax on the same terms as a traditional IRA. The Roth wrapper protects the remaining, non-debt-financed portion; it does not protect the leveraged portion.

The pension-plan exception generally does not cover IRAs

Section 514(c)(9) provides relief from UDFI on real property for certain qualified organizations — principally qualified pension trusts and educational institutions. IRAs are generally not among them. Certain employer-sponsored qualified plans may be, but the exception carries conditions that many partnership investments fail. This is a question for a CPA with direct experience in the area, not an assumption to make.

CHAPTER 3

How the Tax Is Calculated

The debt-financed percentage, step by step

The mechanics come down to a single fraction:

Debt-Financed % = Average Acquisition Indebtedness ÷ Average Adjusted Basis

That percentage is applied to the property's net income. The result is UDFI, taxed inside the account at trust rates.

A worked example

Assumptions: $100,000 invested | deal capitalised with 70% debt | $4,000 of taxable income allocated on the K-1 | figures rounded and illustrative

Step	Calculation	Amount
Your share of taxable income	From K-1	$4,000
Debt-financed percentage	Avg. debt ÷ avg. adjusted basis	70%
Gross UDFI	$4,000 × 70%	$2,800
Less specific deduction	Section 512(b)(12)	($1,000)
Taxable UBTI	—	**$1,800**
Approximate tax	Filed on Form 990-T	~$300–$500

In the operating years the number is usually modest, which leads many investors to treat UDFI as a nuisance rather than a real cost. Two details make that conclusion premature.

Straight-line only	In computing UDFI, depreciation on debt-financed property must be figured on the straight-line method. The cost segregation study and bonus depreciation that make a deal attractive in a taxable account do not reduce the calculation. The shelter you paid for does not travel into the IRA.
Exposure climbs	The numerator is debt; the denominator is adjusted basis. On an interest-only loan the debt stays flat while depreciation reduces basis, so the fraction grows every year the investment is held. A deal starting at 70% can be meaningfully higher by the time it sells.

> *Taken together, these two rules mean the exposure is largest late in the hold — at the moment the deal is most likely to sell. The single number that drives it is the sponsor's loan-to-cost at closing. Ask for it before you subscribe, not after.*

CHAPTER 4

The Exit: Where It Actually Costs You

The part most investors never see coming

Gain on the sale of debt-financed property is itself UDFI. For a disposition, the percentage is computed using the *highest* acquisition indebtedness during the twelve months preceding the sale, divided by average adjusted basis. That share of the gain loses its exemption.

In a value-add multifamily deal, the great majority of total return arrives at exit. The exposure is therefore concentrated precisely where the money is.

Exit scenario	Amount
Original investment	$100,000
Proceeds at sale	$180,000
Total gain	$80,000
Debt-financed percentage at disposition	~70%
Gain exposed to UDFI	**~$56,000**
Gain retaining its exemption	~$24,000

The dollar tax on that exposed gain depends on its character. Long-term capital gain retains its character and is taxed at the capital-gain rates applicable to trusts; depreciation recapture is taxed less favourably; and trust brackets compress sharply, reaching the top ordinary rate at roughly $15,000 to $16,000 of taxable income. The effective rate on a mixed exit commonly lands in the twenties as a percentage of the exposed gain — but this is a modelling exercise for your CPA, not a rule of thumb.

> *It is not the annual number that matters. It is that roughly the leverage percentage of your profit at exit stops being tax-free.*
> *If you are converting to a Roth specifically so the exit will be tax-free, this is the assumption to test before you convert. A conversion is irrevocable.*

CHAPTER 5

What Does Not Trigger UDFI

Matching the right dollars to the right investment

Section 512(b) exempts interest, rents, dividends, and gains; Section 514 pulls back whatever is debt-financed. The retirement-friendly end of real estate is therefore the unleveraged end and the debt end.

Investment type	Typical UDFI exposure
Mortgage funds and private lending	Generally none — interest is excluded
Preferred equity structured as debt	Generally none — confirm characterisation
Publicly traded REITs	Generally none — dividends are excluded
Unleveraged equity in real property	Generally none
Leveraged multifamily syndication	**Yes — proportionate to the debt**
Most leveraged DSTs	**Yes**
Development with a construction loan	**Yes**

As a portfolio principle: retirement dollars suit the income and debt side of real estate; taxable dollars suit leveraged equity, where depreciation works for you and the exit is a capital gain.

Five practical consequences

Paid from inside Your custodian files Form 990-T and pays from IRA assets. Paying with outside personal funds would be an excess contribution. If the account is fully deployed, there may be nothing there to pay with.

Phantom tax Many deals do not distribute in the early years. UDFI does not wait for distributions. It is possible to owe tax in year one on income you have not received in cash.

Depreciation lost	Inside an IRA, K-1 losses shelter nothing on your personal return. You give up the largest tax advantage of the asset class and receive a new tax in exchange.
Gain becomes ordinary	Outside an IRA, exit proceeds are long-term capital gain plus recapture. Inside a traditional IRA, every dollar withdrawn is ordinary income — after UDFI tax has already been paid along the way.
Estimates and state tax	Accounts expecting to owe $500 or more may need quarterly estimated payments, and some states tax UBTI as well. Confirm both with your CPA.

> *The matching principle: if a deal uses leverage, taxable dollars usually keep more of the return. If the only capital available is retirement capital, look to the debt side of the same asset class rather than forcing the equity side into the wrong wrapper.*

CHAPTER 6

Questions to Ask Before You Subscribe

Four questions that reveal whether a sponsor has thought about this

You do not need to become a tax expert. You need to know whether the sponsor has considered the issue, and you need four numbers.

Leverage	What is the loan-to-cost at closing, and is the loan interest-only? This gives you the starting debt-financed percentage and tells you whether it will climb over the hold.
Reporting	Do you provide an annual fair market valuation statement, and by what date do K-1s go out? Your custodian requires the first for Form 5498; your CPA requires the second. Get both commitments in writing.
Experience	Have your prior deals generated UDFI for IRA investors, and roughly how much? A sponsor who has raised from self-directed accounts will have a real answer. One who has never heard the question is telling you something.
Refinance	Do you anticipate a refinance, and how would it affect acquisition indebtedness? A cash-out refinance increases debt and can raise the debt-financed percentage on everything that follows, including the eventual sale.

> *Pro tip: some offering documents state only that the sponsor may provide periodic statements, reports, or tax documents. That is not enough to keep a self-directed account compliant. If the commitment is discretionary, treat it as absent.*

A note on structuring alternatives

Some investors use a corporate blocker — the IRA owns stock in a C corporation which in turn holds the partnership interest. This stops UDFI from flowing through to the account, but the corporation pays entity-level tax, trading one cost for another. It is worth modelling at scale and rarely worth the complexity on a single position. Discuss it with counsel and a CPA before pursuing it.

Final Thoughts

Real estate remains one of the most durable ways to build wealth outside public markets. Nothing in this guide argues otherwise. What it argues is narrower: that the account you buy it with materially changes what you keep.

Leveraged equity in a taxable account gives you depreciation, capital gain treatment at exit, and no UDFI. The same investment inside an IRA gives you none of the depreciation, ordinary income on withdrawal in the case of a traditional account, and a tax on the leveraged share of both the income and the gain.

That does not make retirement capital unusable in real estate. It makes the debt and income side of real estate the better fit for it. The investors who do best are simply the ones who matched the dollars to the structure before they wired the money rather than after.

> *"Ask what you will keep, not what the deal will return. They are not the same number, and the difference is usually the part nobody put in the brochure."*

Important Disclosures

This guide is provided for informational and educational purposes only. It does not constitute tax, legal, accounting, or investment advice, nor a solicitation or an offer to buy or sell any security. Securities offerings are made only to accredited investors pursuant to applicable federal and state securities laws and only by means of a definitive private placement memorandum.

Tax law changes and its application depends entirely on individual circumstances. Statutory references, rates, thresholds, and dollar figures are provided for illustration and were believed accurate at the time of writing; they should be independently verified against current law. All examples are hypothetical, use rounded figures, and do not represent the performance of any actual investment. Nothing here should be relied upon in place of advice from a qualified CPA or tax attorney who has reviewed your specific situation — preferably one with direct experience filing Form 990-T for leveraged real estate held in retirement accounts.

Past performance is not indicative of future results. Real estate investments are illiquid and involve significant risk, including the potential loss of principal.

The Passive Investing Series

Golden Spiral Capital publishes this series for investors who prefer to understand a deal before they are asked to fund one.

Volume	Title
One	The Accredited Investor's Guide to Multifamily Syndication
Two	The Tax Advantages of Passive Real Estate
Three	How to Read a Private Placement Memorandum
Four	Market Selection: Where and Why
Five	Building a Passive Real Estate Portfolio
Six	**The Passive Investor's Guide to UDFI in Your IRA**

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