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Tax Letter
Self Directed IRA (SDIRA)

Recently it came to our understanding that using Self Directed IRA (SDIRA) to fund non tradition IRA investment became a wide spread, popular method to gain higher returns to grow the retirement fund inside IRA accounts, whether directly funded IRA and/or roll over IRA.

Traditionally, funds deposited in an IRA account can only be invested in open market instruments, such as stocks, bonds, mutual funds, and interest bearing accounts, etc. However, recent years earnings and returns from traditional investments are, usually, low and not satisfying. As time went by, more and more IRA owners and their advisors are moving their money from their IRA accounts into auxiliary IRA investment vehicles known as the Self Direct IRA (SDIRA).

In a nut shell, funds transferred into a SDIRA from an IRA technically can be invested in different type of investment vehicles, such as real estate for rental income and/or for capital gain, in non publicly traded business operation or entity for profit, etc.

For Federal income tax purpose, the SDIRA will be treated as an Exempt Organization (EO). Based on the nature of investment and business activity, the SDIRA may or may not be required to file an annual income tax return (Form 990-T).

To determine whether the SDIRA is required to file a tax return or not. The owner of the SDIRA must be aware of the type and nature of the income generated by the investments of the SDIRA. Generally speaking, interest, dividend, rental income and gain from selling stocks and/or bonds will not trigger a need for the SDIRA to file a tax return. Similarly, these type of income generated by a SDIRA will not be currently taxable. According to the Internal Revenue Code (IRC), income generated by SDIRA will be currently taxable if they are either unrelated business taxable income (UBTI) or unrelated debt financed income (UDFI). According to IRC#512, income from investment in a business that is regularly carried on, whether directly or indirectly, will be currently taxable for a SDIRA. Further, according to IRC#514, income generated from debt financed activity will be proportionally subject to current income tax. As long as there are currently taxable income, the SDIRA must file an income tax return and pay tax. The SDIRA is subject to the same tax rate as a Trust. For SDIRA having taxable income over $11,950 in 2013, the marginal tax rate is 39.6%. Tax wise, it is far more expensive than an individual or a Corporation.

Other than the high tax rate for UBTI and UDFI, there is one more expensive tax trap for SDIRA known as “prohibited transaction (PT)”. PT is defined by the IRC as any transactions, directly or indirectly, monetary and/or non monetary, involve or benefit the owner of the SDIRA. Any PT will render the SDIRA invalid. An invalidated SDIRA will be required to pay all taxes retroactively back to the very beginning, plus penalty and accrue interest. Therefore, it could be very expensive.

Although the idea of earning more or higher return for your IRA is desirable, however before agreeing to choose SDIRA as an investment vehicle to achieve your objective, you should perform an extensive analysis before jumping into any recommendation by an advisor.

Thank you

Cho F Chan CPA, Inc.
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