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IRA limited partnership investment triggers tax

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The two principal tax advantages of individual retirement accounts are deductibility of contributions by qualifying individuals and tax-deferred growth in earnings on contributions. However, as revealed in a recent private letter ruling, the latter advantage can be lost if an IRA purchases the wrong type of investment.

Facts.

Early in '96, Frank Bailey's IRA purchased a limited partnership interest in a nonpublicly traded partnership. The partnership receives income from various services it performs for independent tire retailers and receives rent from a warehouse that it built with borrowed funds and partially leases to a tenant. The loan remains outstanding. The partnership agreement calls for partnership income, gain and loss to be allocated among partners in proportion to their capital accounts. As a limited partner, neither Bailey nor the IRA custodian participates in the management of the partnership and the IRA's liability is limited to the amount of its investment in the partnership.

Statutory provisions.

The ruling pointed out that while IRAs are exempt from tax under Code Sec. 408(e)(1) , that same provision also provides that an IRA is subject to the taxes imposed by Code Sec. 511 on unrelated business income of charitable and other tax-exempt organizations. Unrelated business taxable income is gross income from an unrelated trade or business regularly carried on by an organization, less deductions directly connected with the trade or business, as computed in a special way. (Code Sec. 512(a)(1)). For an IRA, an unrelated trade or business is any trade or business regularly carried on by the IRA or a partnership of which it is a member. (Code Sec. 513(b)) Certain types of income, including rents, royalties, dividends, and interest are excluded from unrelated trade or business income. (Code Sec. 512(b)). However, gross income from debt-financed property can trigger unrelated business taxable income under Code Sec. 514 .

Investment triggers unrelated business income.

Against this background, the ruling concludes that the business income received by the IRA from its partnership investment is unrelated business taxable income. It also concludes that the income derived from the rental of the warehouse by the partnership is generated by debt-financed property and is unrelated business taxable income.

Small consolation.

The ruling agreed that Bailey's IRA is allowed a deduction of $1,000 under Code Sec. 512(b)(12) in computing its unrelated business taxable income. Thus, Bailey's IRA has to pay income tax only to the extent its unrelated business taxable income exceeds $1,000.

RIA observation: An IRA investment in a publicly traded partnership that's treated as a corporation doesn't trigger unrelated business income tax. On the other hand, an investment in a publicly traded partnership that is a partnership is treated just like any other partnership for purposes of taxing the IRA. Thus, business income passed through to the IRA would be taxed whereas passed through items such as interest and dividends would escape tax.

References:

For exempt status of IRAs, see FTC 2d/FIN ¶ H-12214 ; TaxDesk ¶ 28,390 ; TG ¶ 8960 .