

# Private Debt in IRAs: Understanding UBTI, UBIT and UDFI



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**J**eff Smallowitz' article in the Spring, 2025 *Points of Interest*, "Unlocking Opportunities: A Guide to Lending to and from Self-Directed Retirement Plans" illustrates the complexity involved with private debt investments made through retirement plan vehicles such as self-directed IRAs and single-participant 401(k)s.

There are numerous benefits to exposing retirement funds to private debt investments, including improving portfolio diversity, lowering the portfolio's correlation to public markets, and investing in an asset with autonomous, creative and engaged management.

When expanding on Mr. Smallowitz' article, it is important to understand and be able to articulate the concepts of unrelated business taxable income (UBTI), the taxation on this income – unrelated business income tax (UBIT), and unrelated debt-financed income (UDFI).

<b>UBTI</b>	<b>Unrelated Business Taxable Income</b>
<b>UBIT</b>	<b>Unrelated Business Income Tax</b>
<b>UDFI</b>	<b>Unrelated Debt-Financed Income</b>

## The Relationship Between the IRA, UBTI and UBIT

The core intent of an IRA is to create and build wealth for one's retirement. As such, assets acquired for IRAs are expected to fit that purpose and intent. They are expected to grow in value, using a stated strategy, and to generate income or improvement in overall value. Typical IRA investments in listed securities, bank products and mutual funds generate passive income such as dividends and interest, which align with the IRA in purpose and intent. The income generated by these events remain tax-deferred under the umbrella of the IRA.

Investment as an endeavor, though, is opportunistic. Some investments generate active income external to the intent of the IRA and to the intent of the investment, whether expected or unexpected. This income becomes UBTI and is taxed as UBIT. Examples of investments that may generate UBTI and create UBIT for the IRA are:

- Private peer-to-peer lending
- Real estate purchased with non-recourse loans
- Limited Partnerships and Limited Liability Companies, particularly using leverage or investing in the energy sector
- Assets that ultimately run a business such as a restaurant or manufacturing facility
- Private debt funds involved in the business of institutional buy-outs
- Consistent and frequent real estate acquisitions using debt financing

## The Place of UDFI in the Relationship

UDFI enjoys a distinct place in the relationship of the IRA, UBTI and UBIT, particularly when leverage is used. In the case that a pooled debt fund generates income from a debt-financed buy-out, the income generated from such event would be considered UDFI and taxed as UBIT.

This applies to both leveraged buy outs in pooled debt scenarios, as well as the funding of real property acquisitions using borrowed money. It is important to note

that this tax realization is not limited to pooled funds, but to direct investments as well, such as investment in a real estate position where the IRA has utilized a non-recourse loan to fund a portion of the total purchase.

## Operationally Dealing with UBTI, UBIT and UDFI

Taxing income generated by assets held under an IRA umbrella is counter-intuitive, as the income generated by IRA investments is typically tax-deferred. This makes handling and articulating UBTI, UBIT and UDFI difficult. There are important nuances to remember that ease this burden, and some relief provided by IRA Custodians.

Since UBIT is aligned with an asset held in an IRA, the IRA must take the action of paying the tax. Put differently, the IRA beneficial owner cannot pay the tax from individual funds. Rather, the tax payment must come from funds held in the IRA. This does somewhat release the beneficial owner from an operational burden.

Payment, then, becomes an operational service of the IRA's Custodian. The Custodian is notified by the issuer of a pooled fund via Schedule K-1 or other document. Upon receipt, the Custodian will file IRS Form 990-T and pay the tax from funds held in the IRA. Some Custodians may outsource this process to a third-party, but the rules are clear that the IRA beneficial owner cannot make payment with personal funds.

Because the funds are paid from, and the reporting references the IRA, there is one additional step that must be taken. This

*continued on page 24*

is to create an employer identification number (EIN), which facilitates proper receipt with the IRS. This EIN must be opened in the name of the IRA, which includes the Custodian's name. An EIN can be applied for through the IRS website and may be a service of the Custodian, outsourced to a third-party, or may be an action the Custodian expects of the beneficial owner.

Private debt is an important component in the world of alternative investments. Retirement plans' appetite for alternatives, both on the equity and debt side will continue to grow. For this reason, those advising clients and working as private lenders should have a high-level understanding of UBTI, UBIT and UDFI.

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