For 2016, the IRS is adding a compliance question to the Form 5500 to identify retirement plans that have unrelated business taxable income ("UBTI"). The question was originally added for 2015, but recent guidance instructed filers not to complete the question. Generally, retirement plans are not subject to taxation until retirement benefits are paid from the plan. However, if a plan has investments which generate UBTI, the plan will be required to pay taxes.

What is UBTI? UBTI is income derived from the unrelated business activities of an otherwise tax exempt entity, a qualified retirement plan for this discussion. UBTI prevents tax exempt entities from competing unfairly with taxable entities. For example, without UBTI, a plan’s trustee could invest the assets of the plan in an actively run business. The income from that business would not be subject to taxes which would allow the business to achieve higher profit margins or sell its products at a lower cost than competitors. Even if the plan is not operating an active business, plan investments in MLPs (master limited partnerships) and LLCs, both of which may be publicly traded, can generate UBTI. MLPs and LLCs are pass-through entities whereby the income from the underlying operating business is passed through to the plan via a Schedule K-1.

What is Unrelated Debt-Financed Income? A second source of UBTI occurs when a plan uses borrowed funds to purchase investments. The interest, dividends, capital gains, etc. earned from debt-financed securities result in UBTI. Examples of debt financing include purchasing securities on margin and borrowing against life insurance contracts to purchase securities.

How is the tax paid? A plan subject to UBTI pays tax on the income at trust tax rates. A retirement plan receives an exemption for the first $1,000 of income. After that, the plan pays the tax at trust tax rates which range from 15% at $2,550 of income to 39.6% for income over $12,400 for 2016. The retirement plan is required to file a Form 990-T. The tax must be paid by plan assets.

What should you do? The addition of this question to the Form 5500 indicates the IRS will be more focused on the reporting of UBTI. If you don’t know whether your assets may result in UBTI, contact our office or your financial advisor for a review. If you receive a Schedule K-1 for any of your plan investments, forward copies to our office as soon as possible.