ED SLOTT'S IRA ADVISOR

April 2009

Tax & Estate Planning For Your Retirement Savings

Deducting IRA Losses

See pages 2 - 4

"If I'd just listened to CNBC I'd have a million dollars today, provided I started with a hundred million dollars."
- Jon Stewart on The Daily Show with Jon Stewart

Everyone has lost money in the stock market and that includes those with IRAs and other retirement savings accounts. The first question most clients will have is how to benefit from these losses by deducting them and reducing their tax bill.

Unfortunately for IRA owners, it is not that simple because this is mostly tax-deferred money and is subject to special rules not applicable to other non-IRA investments.

A client cannot take a deduction for a loss in value when the funds remain in the IRA.

That's the topic of our feature article ***"Deducting IRA Losses."*** Although many technical hurdles apply, tax deductions can be claimed for IRA losses, but only once the funds (that is, all funds in all IRAs) are withdrawn. A client cannot take a deduction for a loss in value when the funds remain in the IRA, just as he does not have to pay tax on gains within the shelter of the IRA.

What makes this market decline worse than ever before is that not all of the losses are market related. Scores of savers have been victims of outright fraud. Bernard Madoff and a growing list of others have caused losses that are still undetermined. How can IRA owners deal with these types of losses?

For those answers we turn to this month's Guest IRA Expert, Robert S. Keebler, CPA, MST, DEP, shareholder in the accounting firm Virchow, Krause & Company, LLP, Green Bay, Wisconsin. Bob has been on a mission to sort this out for investors and IRA owners who are left with losses and confusion.

Bob's article ***"Investment Fraud Losses"*** highlights the thorny issues of how to deduct investment losses due to fraud. It includes the most recent guidance from IRS, Revenue Procedure 2009-20 and Revenue Ruling 2009-9, which were both issued on March 17, 2009. There are still many more questions than answers, but Bob raises many issues and details the types of losses that can be claimed and how to show them on tax returns.

For more IRA information, visit our website at ***www.irahelp.com***.

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WHAT'S INSIDE?

Deducting IRA Losses

Advisors are getting this question more than ever before. Can I deduct the losses I incurred in my IRA?

The answer will depend partly on what type of loss the client has suffered. There has been virtually no guidance for losses due to theft or fraud but there are existing procedures for deducting losses due to a drop in market value. The following procedures apply to market value losses (for theft and fraud losses, see the end of the article).

There is never a deduction for losses within an IRA. Just as the IRA owner is not taxed on gains in the IRA when they are earned, he cannot deduct losses in the IRA when they occur. But, for tax purposes, it may be possible to deduct IRA losses if all the funds are withdrawn from all the IRAs a client owns.

For a traditional IRA, it means that all of the funds from all of his traditional IRAs must be withdrawn, including SEP and SIMPLE IRAs. He does not have to withdraw any funds from Roth IRAs or inherited IRAs to claim a loss on the traditional IRAs.

To deduct losses on Roth IRAs, the same rule applies. All funds must be withdrawn from all Roth IRAs.

IRA Withdrawal Caution

In general, withdrawing all of the remaining funds from an IRA or Roth IRA solely to claim a tax loss is a poor move. Not only is the tax loss often much less than you might think, or sometimes nothing at all, but the client has permanently decreased his tax-deferred (or tax-free with a Roth IRA) retirement savings by the amount withdrawn.

Before you advise anyone to withdraw all of their IRA or Roth IRA funds in order to claim a loss, make sure they can deduct that loss. You don't want to have a large distribution and then find out that no loss can be claimed or deducted. You also want to make sure that your client understands that the funds being withdrawn will no longer be in a tax sheltered account. Those funds cannot go back in, other than in annual IRA or Roth IRA contributions, but those limits are low. It would take years to replace a large withdrawal from the IRA.

IRA Loss Deduction Rules

With the above caution said, if your client wishes to continue the next step is to see if there is actually a loss. Your client will likely say "Of course, there is a loss. Look at my statement. I had $850,000 in my IRA and now I have $500,000. Isn't that a loss?"

Deducting IRA Losses

6 Tests to Pass

1. There must be basis (the IRA must contain non-deductible IRA contributions or after-tax funds transferred into the IRA from a company plan). All funds contributed or converted to Roth IRAs are basis.

2. Roth IRA: All funds from all Roth IRAs must be withdrawn.

   Traditional IRA: All funds from all traditional IRAs (including any SEP or SIMPLE IRAs) must be withdrawn.

3. The amount of the basis (the nondeductible contributions) must exceed the amount withdrawn.

4. Must itemize deductions (as opposed to taking the standard deduction). The loss is claimed as a miscellaneous itemized deduction.

5. The total of all miscellaneous itemized deductions (including the IRA loss) must exceed 2% of AGI.

6. Must NOT be subject to the alternative minimum tax. The loss deduction is lost if subject to AMT.

Even when these six tests are passed, for those under age 59½, Roth IRA distributions could be subject to the 10% early withdrawal penalty if converted Roth IRA funds are withdrawn within 5 years of the conversion.

Yes that is a loss in value, but for tax purposes a loss can only be claimed if there is "basis." A client might ask: "Where do I get this 'basis,' so that I can claim my loss? Do they have basis at Home Depot… they have everything else there?"

Basis is money that has already been taxed. If the client received a tax deduction for his traditional IRA contributions, he has no basis, since that money has not yet been taxed. Likewise, any earnings in the account have also never been taxed, so earnings can never be basis.

Basis is created by making non-deductible IRA contributions or by rolling over after-tax funds from an employer plan to an IRA. Since traditional IRAs generally include mostly deductible contributions and rollovers from company plans that were also deductible contributions, it is not likely that a loss can be claimed, even if all the funds from all of the traditional IRAs were withdrawn.

It is more likely a client would be able to claim a loss for a Roth IRA.

It is more likely a client would be able to claim a loss for a Roth IRA. All Roth IRA contributions are basis since there is never a tax deduction for a Roth IRA contribution. Roth conversion funds are also basis since income tax is paid on those funds when they are converted. But earnings in a Roth IRA are not basis because those funds have not been taxed, even though they may never be taxed.

IRA and Roth IRA beneficiaries can also have basis, since any basis carries over to beneficiaries at death. Most beneficiaries miss this when they take distributions, because they don't know to ask and their advisors (and even their CPAs) often don't pick up on this. For a beneficiary to use these loss deduction rules, she would have to cash out all IRAs or Roth IRAs inherited from the same individual.

IRA Loss Deduction Examples

Example 1:
Traditional IRA

Joe had $850,000 in his traditional IRA early in 2008 and that value declined to $500,000. Joe says, "I took a beating (join the club, Joe) and I want to deduct that $350,000 loss." Before advising Joe to take all of the funds out of his IRA (and remember that those funds cannot go back in if you claim a loss deduction), first see if Joe can even claim a loss. Did Joe have basis? Yes. In this example let's assume that over the years Joe made $30,000 in non-deductible traditional IRA contributions.

The $500,000 remaining in Joe's IRA exceeds the $30,000 basis, so even though Joe has basis, he still cannot deduct a loss and it would not pay to withdraw the $500,000. Even if somehow Joe did have enough basis to claim a loss on this account, he should still be advised not to empty a $500,000 tax deferred account, unless he absolutely needed the funds as a last resort. It might take him a lifetime to make that up.

Example 2:
Traditional IRA

Mindy has only one traditional IRA and it had a balance of $100,000 early in 2008 but that account was decimated in the market crash and is now only worth $20,000. Over the years, Mindy made $25,000 in nondeductible traditional IRA contributions. If Mindy withdraws the entire $20,000 remaining in her IRA, can she claim a loss on her taxes?

Yes, because Mindy has basis of $25,000 and that exceeds her entire remaining account balance of $20,000. Mindy can claim a loss of $5,000.

Example 3:
Roth IRA

Pam has only one Roth IRA and it had a balance of $100,000 early in 2008 but that account is now only worth $20,000. The original $100,000 consisted of an $80,000 Roth conversion plus $20,000 of earnings on those converted funds. If Pam withdraws the entire $20,000 remaining in the account, she can claim a tax loss of $60,000. Pam's basis in the account is $80,000 (the converted funds). Remember that the earnings she once had do not count as basis. Since Pam's remaining Roth IRA balance withdrawn is less than her basis, she can claim a loss on the difference ($80,000 basis less $20,000 remaining balance = a $60,000 loss she can claim). The $60,000 loss is the amount of her basis that was not recovered. If Pam has not held that conversion for at least 5 years and she is under the age of 59 ½, she will have to pay the 10% early distribution penalty on the $20,000 she withdraws.

Example 4:
Roth IRA

Bill converted his $100,000 traditional IRA to a Roth IRA in early 2008. This is Bill's only Roth IRA and the value has now tanked to only $20,000. If Bill withdraws the entire $20,000 remaining in the account, he can claim a tax loss of $80,000. There were no earnings on the account since the value just kept declining. The $100,000 converted is basis. Since Bill's basis exceeds the amount he withdraws when he empties the account, he can claim a loss on the difference ($100,000 basis less $20,000 remaining balance = $80,000 loss he can claim). The $80,000 loss is the amount of Bill's basis that was not recovered.

The problem with this plan is that Bill still has to include the $100,000 Roth conversion in his income this year which will only be, at best, partially offset with a loss deduction; and that assumes that he will actually get a deduction. A big loss like that could trigger the alternative minimum tax (AMT) and Bill would lose the ability to deduct that big loss. If he cannot deduct the loss, he is out the entire tax he paid on the conversion. That could be a $35,000 tax cost (the tax paid on the conversion) to end up with only $20,000.

In addition, if Bill is under age 59½, and he has not held the converted funds for at least 5 years, then the $20,000 he withdraws when he liquidates his Roth IRA is subject to a 10% early withdrawal penalty.

Roth Recharacterization Strategy

Better Option – Roth Recharacterization

Since this Roth IRA conversion occurred in 2008, it can still be undone (recharacterized) and no tax would be owed on the $100,000 conversion. Bill has until October 15, 2009 to recharacterize his Roth IRA conversion and remove the entire tax liability on value that no longer exists.

If he recharacterizes his 2008 Roth conversion in full before he files his return, Bill will report both the conversion and the off-setting recharacterization on his tax return and won't have to pay any conversion tax. His net taxable conversion will be zero. If Bill has already filed his 2008 tax return and then later recharacterizes (before October 15, 2009), Bill will have to file an amended tax return to receive a refund of the conversion tax paid on his 2008 return.

By choosing the recharacterization, Bill fares much better. Yes, Bill still lost $80,000 of value, but at least he is not paying tax on that loss. Under the scenario above where he keeps the conversion and then claims a loss, he ends up with much less, even if he is able to deduct his loss. In either case, $80,000 of value is lost, but the recharacterization removes the entire tax liability on the conversion and the $20,000 of value that's left stays in a traditional IRA growing tax deferred.

For Bill, the Roth recharacterization option was still available since the conversion was done in 2008. As long as that option is still available, that is always going to be a better option than trying to claim a loss. If Bill wishes, he can re-convert the $20,000 that is now back in his traditional IRA to a Roth IRA. In this example, to reconvert he must wait until 30 days after the recharacterization. If the conversion is from prior years, it can no longer be recharacterized. In that case, claiming the loss is the next best option.

Claiming vs. Deducting an IRA Loss

Being able to claim a loss does not necessarily mean your client will be able to actually deduct that loss. There are still additional hurdles.

The loss cannot be claimed if the client takes the standard deduction. The loss can only be claimed as a miscellaneous itemized deduction subject to the 2% of adjusted gross income (AGI) limitation. Only miscellaneous itemized deductions that exceed 2% of AGI can be deducted. The loss on an IRA or Roth IRA is included in that total. If the loss is large enough, it will be more advantageous to itemize deductions rather than using the standard deduction.

If this hurdle is passed, and your client's 2008 AGI exceeds $159,950 (or $79,975 only for those filing married-separate), part of the deduction can be further limited.

In addition, even if the client is still in the running after the above challenges, he can lose the entire deduction if he gets hit with the AMT. Under AMT all of the 2% miscellaneous itemized deductions are lost, including any deduction that might be claimed for IRA losses.

IRA Losses Due to Fraud

New Fraud Loss Guidance Issued by IRS March 17, 2009

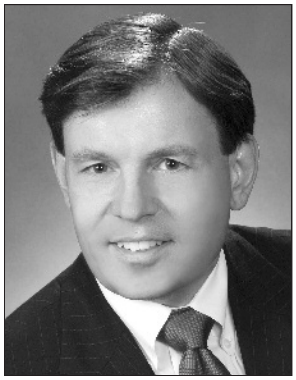
Revenue Ruling 2009-9
Losses due to criminal investment fraud or embezzlement can be deducted under IRS Code Section 165(c)(2), as a theft loss (a transaction entered into for a profit). It is not a capital loss and is not a casualty loss. In addition, the deduction is not lost if alternative minimum tax applies.

Revenue Procedure 2009-20
Provides a safe harbor method to deduct investment fraud losses.

On March 17, 2009, IRS released Revenue Procedure 2009-20 and Revenue Ruling 2009-9 which provided guidance for deducting theft or fraud losses in investment accounts but provided no guidance for retirement accounts. However, it seems logical that once the remaining IRA funds have been withdrawn in full and there is an established loss in an IRA, that the account owner should be able to deduct the loss using these more favorable new provisions.

The new rules allow up to 95% of the loss to be fully deductible (75% for those suing third parties) and, unlike market value losses, fraud losses are not subject to the 2% of AGI limitation, the 10% of AGI limitation (for casualty losses) or to AMT. This could be a huge benefit for retirement account owners who have been victims of investment fraud. ■

Guest IRA Expert



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Investment Fraud Losses

A continuously updated outline on potential Madoff tax issues is available at:
www.virchowkrause.com
Search: Madoff

For months Bernard Madoff has been in the headlines, but his is not the only reported incident of investment fraud to have surfaced recently. The SEC has accused Robert Allen Stanford of running an $8 billion scheme; other promoters also have been charged with improper actions. Shrinking asset values have been likened to a receding tide, exposing small as well as large plots to rip off investors.

As an advisor, you may have clients who have been victimized by a fraudulent investment promoter. Those clients might have suffered substantial losses from their IRAs and other investment accounts. In such situations, what can you do to help?

Investment scams are often structured as Ponzi schemes. Initial investors get "returns" that really come from the contributions of later investors. If that has occurred, the money paid out to early investors may be considered available for recovery by later victims.

On March 17, 2009 IRS released Revenue Procedure 2009-20 and Revenue Ruling 2009-9 in response to the recent investment fraud cases.

The Role of the SIPC

Assuming that your client has been defrauded by a brokerage firm or someone affiliated with a brokerage firm, you should tell him or her to file a claim with the Securities Investor Protection Corporation (SIPC). An online claim form is available at www.sipc.org. SIPC protects brokerage accounts up to $500,000 per customer, including $100,000 in cash. That coverage extends to theft or loss of securities, not to losses because market values went down.

Keep in mind that the SIPC is not a government agency. It's an industry effort funded by brokerage firms. Considering the volume of likely claims and the current financial problems facing some large brokers, we'll have to wait and see whether all claims can be paid up to the $500,000 limit or whether the federal government will step in.

Tax Options

Some clients who have fallen victim to investment fraud might get a full or partial recovery from the SIPC and from the assets of various participants in the scam.

Suppose, for example, you represent John Smith who lost his $1 million investment in a Ponzi scheme. John might say that he lost $1 million but expects to recoup $600,000; $500,000 from the SIPC plus $100,000 from other assets that turn up. John would then report a $400,000 theft loss on his tax return. Note that John will start with a $1 million loss. That will be the case even if John has received statements from the promoter saying that his "account" was worth $1.2 million, $1.5 million, or more. (John also would file a "protective" claim in case he recovers less than $600,000 in future years.)

However, on March 17, 2009 IRS released Revenue Procedure 2009-20 and Revenue Ruling 2009-9 in response to the recent investment fraud cases. These releases clarify that a Ponzi scheme investment loss is a theft loss and provide guidance on how to report the loss on a client's tax return.

Under this guidance, John would multiply the amount of the original investment by 95% ($1,000,000 x 95% = $950,000) if John were not pursuing or intending to pursue any potential third-party recovery (otherwise, the percentage decreases to 75%). John would then subtract the amount of any actual recovery and any potential insurance/SIPC recovery, leaving him with $450,000 ($950,000 - $500,000). Pursuant to Rev. Proc. 2009-20, he does not have to further reduce this amount by the $100,000 potential direct recovery or potential third-party recovery. Accordingly, John would be able to claim a deduction of $450,000.

Theft Loss – Tax Code Section 165(c)(2)

Under this approach, John would claim the loss as an itemized deduction; it is considered a loss in an activity engaged in for profit. The tax code defines losses under this category as "losses incurred in any transaction entered into for profit, though not connected with a trade or business." The loss is NOT reduced by the 10% adjusted gross income (AGI) limitation (for casualty and theft losses) or by the 2% AGI limitation for most other miscellaneous itemized deductions. The loss is exempt from alternative minimum tax (AMT), meaning that if AMT applies, the loss can still be claimed.

Revenue Procedure 2009-20 contains an optional safe harbor provision for claiming a theft loss deduction related to a fraudulent investment arrangement on an investor's tax return. There is a two page form for the investor to fill out and file with their tax return. It takes you through a calculation to determine the amount of the loss. For these types of losses, the calculation will include additional investments put in, income reported on the investment, and distributions made from the investment. The investor is allowed to take an immediate deduction for 95% of the loss, if there is no lawsuit against a third-party, or 75% of the loss if pursuing recovery from a third-party.

IRS challenges for treatment of these losses as theft loss deductions will be limited when an investor uses the safe harbor provision. The investor is also eligible to modify the calculation in future years if there is additional income or a smaller amount is recovered.

Investors must file Form 4684, "Casualties and Thefts", with their tax return for the year of discovery of the theft. At the top of the form they should write "Revenue Procedure 2009-20." The amount of the deductible theft loss from line 10 of the two page form is entered on line 34 of Form 4684. The completed and signed two page form is attached to the investor's tax return for filing with IRS. While casualty and theft losses claimed on Form 4684 are reduced by 10% of AGI and $100 for each loss, under the new IRS ruling and procedure, those limitations no longer apply to theft losses from criminally fraudulent investments.

An investor can still claim a deduction under Tax Code Section 165(c)(2) without using the safe harbor provision. However, IRS says that returns claiming those deductions will be "subject to examination."

IRA Fraud Victims

What can you do for clients who have been defrauded of funds in a retirement account holding mainly pre-tax dollars? The requirement that clients can use only their basis in securities to report losses can be a problem. Suppose, in the above example, John's $1 million investment had come from his IRA. All of the money in that account came from pre-tax contributions. John has no basis in his IRA. He can't claim a tax loss on his tax return, even though his IRA money was stolen. This may be hard to explain to clients. If John's IRA is ripped off by a brokerage firm or someone affiliated with the firm, the SIPC will provide restitution up to their limits.

As illustrated above, John Smith lost a $1 million IRA and expects $600,000 of restitution from various sources. After receiving restitution, he can request a Private Letter Ruling from IRS to allow him to put that $600,000 back into an IRA where it would be treated as pre-tax money. In addition, the client can ask that redeposited dollars be excluded from taxable income. IRS has granted several such requests in the past.

It is expected that IRS will continue to issue guidance on these types of issues related to the Madoff affair. If blanket permission is granted to restore pre-tax dollars, it may be reasonable to infer that such permission extends to other investment frauds involving retirement accounts.

Roth IRA Loss Recovery

A theft loss deduction under the newly released IRS rules (Revenue Ruling 2009-9 and Revenue Procedure 2009-20) could potentially be available in relation to Roth IRAs because Roth IRAs have basis since they are funded with after-tax dollars. There is currently no guidance from the IRS on whether this is a remedy available to a Roth IRA, but practitioners should consider filing protective claims to leave this possibility open for clients whose Roth IRAs were lost in an investment scam. Under the new loss rules, the Roth IRA loss will not be wiped out if the AMT applies, as many IRA losses are that are claimed as miscellaneous itemized deductions. But again, there is still no guidance from IRS as to whether these new theft loss deduction rules can apply to IRA losses.

There is still no guidance from IRS as to whether these new theft loss deduction rules can apply to IRA losses.

Suppose Jane Jones retired with $1 million in her 401(k) account. She rolled that amount to a traditional IRA and later converted the entire account to a Roth IRA, paying $350,000 (35%) in tax to the IRS.

If Jane converted her IRA to a Roth IRA in 2008, she can recharacterize the conversion up to October 15, 2009. This is the simplest and surest way to get her $350,000 tax payment back. For years prior to 2008 where the October 15th deadline for those years have passed, taxpayers should consider applying to IRS for a PLR to allow for a late recharacterization for an open year under Treasury Reg. § 301.9100-3. IRS has allowed late Roth IRA recharacterizations in prior PLRs. Unfortunately, PLRs are very costly and the dollars involved in the conversion may not support the expenditure.

After the recharacterization, Jane now will be in the same position as if she had lost all the money in her pre-tax IRA. She can ask the IRS for permission to redeposit any subsequent recoveries in an IRA, as explained above.

If Jane converted her IRA to a Roth IRA prior to 2008, her best tactic may be to claim a loss for tax purposes. In this example, her basis in the Roth IRA is the $1 million on which she has paid income tax.

To get a loss, Jane must cash out that Roth IRA as well as any other Roth IRAs she has. If her basis is $1 million and she gets zero from closing the account, her initial loss is the difference: $1 million.

If she expects $500,000 from SIPC and $100,000 from other recoveries, she can claim a $400,000 loss.

There is another tactic to consider, assuming this client reported the income from a Roth IRA conversion on a tax return filed within the last three years. In that case, the client could amend that return and ask for a refund of the tax paid on the Roth IRA conversion, plus interest. The client's position would be that his or her traditional IRA held no assets at the time of conversion, so no taxable income was recognized on the conversion.

The IRS has not always approved refunds of taxes paid on reported income. Nevertheless, this tactic might be worth a try if a client has no other practical way to get tax relief for a Roth IRA lost in an investment scam.

Recouping Fraud Losses

• A client who takes a deduction for a non-IRA estimated theft loss also should file a protective claim if they are not planning on utilizing the safe harbor of Revenue Procedure 2009-20. That's a claim for a potential refund based on a contingent event that might occur after the statute of limitations expires. Thus, if a client's hopes of recovery are dashed years in the future, the client could deduct an additional theft loss. This is automatically allowed for under the safe harbor provisions of Revenue Procedure 2009-20.

• Clients who have been defrauded should get some restitution from SIPC and some other recoveries. Ideally, IRA clients can deposit restored pre-tax IRA dollars to an IRA.

What if clients lost money in both taxable and tax-deferred accounts? Suppose Barbara Evans lost a total of $2 million in a Ponzi scheme, including $500,000 in her traditional IRA. If Barbara receives $500,000 from SIPC, she might like to put all $500,000 back into her traditional IRA, as pre-tax dollars. However, she'll only be allowed to put $125,000 back into her IRA; 25% of her total loss was from her IRA so 25% of her recovery might go back into the IRA, assuming IRS permission.

• Some clients may have inherited non-existent assets from an estate that paid estate tax. Here, there might be grounds for amending the estate tax return. If the estate included an IRA, the client should look into amending tax returns and making adjustments to IRD (income in respect of a decedent) deductions.

• Some clients may have divorce settlements that now contain non-existent assets. If those investments didn't exist at the time of the divorce settlement, your client should consult with an attorney about asking to readjust the division of marital assets.

Advisor Action Plan

• Canvas clients to see if any of them lost money to Bernard Madoff or any other alleged investment fraud artists.

• Refer such clients to a local attorney who can provide advice on filing lawsuits and recovering assets.

• Advise clients to fill out an SIPC claim form.

• Items to discuss with the client's tax advisor:

1. Requesting a PLR asking the IRS for permission to restore any recoveries to a pre-tax account.

2. Which tax strategy to pursue. That might be a recharacterization of a 2008 conversion, a cashing out of the Roth IRA and a loss deduction, or an amendment of a prior year's return to claim a refund on a bogus Roth IRA conversion.

3. Whether or not the client should use the newly issued IRS loss deduction rules (Revenue Ruling 2009-9 and Revenue Procedure 2009-20) issued March 17, 2009. ■

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ED SLOTT'S IRA Advisor

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