" A wise man makes his own decisions, an ignorant man follows the public opinion."
— *Chinese proverb.*

Feature

IRA

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IRA Losses ? Can You Deduct Them or Not?

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Technical Terms
- Adjusted gross income (AGI)
- Deduction
- Roth IRA
- Traditional IRA

Related Reading
- IRA Distribution Tax Rules

Jeff opened an IRA in 1987 with $2,000, and after more than a decade of investing the money in a variety of high-risk ventures, it's now worth $300. He's wondering what to do with the account.

"I would like to close it," said Jeff (a pseudonym; he asked that his real name not be used). He's wondering how he can take the loss off of his taxes.

Jeff is not alone. With the market down sharply this year, some folks who have seen substantial drops in their IRA balances want to know how they can take these losses off their taxes.

Accountants and financial planners expect some of their clients to ask this question for the 2001 tax year. "I would expect to see a couple of these," said Patricia Harik, a certified public accountant (CPA) with Zdonek & Wolwicz Accountancy Corp. in Torrance, CA.

Many experts will tell you that IRA losses may not be deducted from your taxes, and they are correct with respect to investment losses. **You may not deduct investment losses in your IRA from your taxes.** Your investment gains would be the appreciation in your account above your original contribution, and investment losses would be the reduction of those gains.

Still, there are several special circumstances under which IRA losses may be tax-deductible. But, it's likely these will only apply to a small number of IRA and Roth IRA owners ? those who made after-tax contributions to their accounts, and whose balances are smaller than their after-tax contributions. Figuring out if you qualify for a loss is complicated. "I wouldn't do this at home. ... You should check with someone who knows what they are doing," said Ed Slott, CPA and editor of *Ed Slott's IRA Advisor*.

Basics on Basis

Before getting into the discussion about what deductions are permitted, it's important to understand you can't deduct investment losses (declines in your earnings) or losses in tax-deductible contributions.

In order to declare a loss on your taxes from your IRA, the account needs to have what is called basis. If you normally trade securities outside of an IRA, you are probably familiar with this term, because it is used in calculating capital gains and losses. Basis is the purchase price of a piece of property or a security, plus or minus any adjustments. Basis must be earned. It is created when you spend after-tax money on an investment or property, but can be reduced by tax deductions you receive.

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This is why a $2,000 tax-deductible IRA contribution has no basis and why the investment gains on any IRA contributions don't have basis. And this is Jeff's main problem: his IRA contributions were tax-deductible, so his losses don't qualify to be taken as a deduction.

Two types of IRA contributions, however, do have basis ? Roth IRA contributions and nondeductible traditional IRA contributions. Both of these are made with after-tax dollars.

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However, the earnings generated by your contributions (even contributions with basis) will *not* have basis.

Deducing a Deduction

Here's the next hurdle. The only way the IRS will allow you to determine if you have a loss in your IRA is if you liquidate it and any other IRAs you have, explains John Karayan, a tax attorney and professor of business at the University of California Riverside. "You have to cash out," he said.

So, if you decide you want to deduct a loss in your Roth IRA, for example, you have to engage in kind of a scorched-earth practice. You must liquidate all your Roth IRAs and see whether your liquidated balance is less than your combined contributions to all the accounts. If it is, you have a loss.

The first place where some people may get tripped up is this liquidation requirement. Suppose you have two traditional IRAs, one holding nondeductible contributions and the other holding funds rolled over from a 401(k) or other employer plan. You will have to liquidate both accounts to determine if you have a loss. And it's possible the taxes you may have to pay on the account holding the rolled-over 401(k) money (which is funded with tax-deferred contributions) could erase any advantage from writing off the losses in your contributory IRA.

By the way, since nondeductible IRA contributions weren't permitted until 1987, the most basis this type of account could have in 2001 is $30,000 (15 years x $2,000 a year = $30,000). If you want to claim losses from nondeductible IRAs you will need to have your records of nondeductible contributions reported on IRS form 8606.

Here's how you would calculate a loss: Suppose you made a $2,000 nondeductible IRA contribution in 1999 and made nondeductible contributions of $2,000 in 2000 and again in 2001. Your total contribution is $6,000. Today, the account is worth $1,500. The $4,500 decline is the loss you might be able to deduct from your taxes. The problem is that qualifying for the deduction is an obstacle-filled process.

With a Roth IRA you won't have to pay income tax on after-tax contributions you liquidate, but Roth contributions that came from a converted traditional IRA may be subject to the 10 percent early withdrawal penalty, if you are younger than 59?. What's more, any Roth IRA-holder, even over 59?, will have to pay this penalty now. This is because the account must be held for five years before the penalty requirement expires. As Roth IRAs were introduced in 1998, the first qualified, or penalty-free, withdrawals can only be taken starting in 2003.

Liquidating your IRAs in order to realize a loss also raises the question of where else you could invest this money and get the tax advantages offered by an IRA, Karayan said. "Do you want to pull your money out of a tax-free investment?" he asked, referring to a Roth IRA.

Also, even if you have a potentially deductible loss, you still may not be able to take it all off of your taxes. There are several criteria you need to meet:

- Losses of this type are considered miscellaneous itemized deductions, Slott said. You must itemize your tax return in order to take this deduction. Not all tax filers can itemize their returns.
- If you itemize, the deduction then becomes subject to three IRS restrictions. A qualified tax planner can help you determine if your deduction will be limited. The first limit is the 2 percent limit on your adjusted gross income. Next your deduction could be reduced by the overall 3 percent reduction of itemized deductions. Finally, your deduction might be subject to the Alternative Minimum Tax (AMT). Slott explains that the AMT snags most miscellaneous itemized deductions.

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? Gayle Buff, CFP with Buff Capital Management of Newton, Mass.

With these restrictions and the 10 percent penalty tax, it may not be worth it to take the deduction.

It's also likely that a saver who has been contributing to an IRA over many years won't qualify for a deduction, CPA Harik suggests. The reason, she said, is that someone who has invested that long likely has accumulated enough investment gains to put his or her account balance in positive territory with respect to contributions, despite the market's sharp declines.

Your Investment Strategy

Certified Financial Planner (CFP) Gayle Buff, with Buff Capital Management of Newton, Mass., said savers with such substantial losses in their IRAs have another issue to deal with ? their investment strategy.

"Maybe the IRA isn't the place for people to take this risk and suffer this kind of loss," she said. She suspects that savers trying to figure out how to deduct IRA losses from their taxes didn't understand the risks associated with the investments they were using. Indeed, she said during the bull market of the 1990s she often battled with clients to diversify their portfolios and minimize their exposure to high-risk investments. "Its not until things go down that they understand what risk is," she said.

"I would use this as an opportunity to lecture" savers that they should take the time to understand the risks and rewards of the investments available to them, Buff added.

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