THE Pension Digest

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ALSO IN THIS ISSUE –

IRAs AND THE APPLICATION OF

The Graham-Leach-Bliley Act of 1999 was signed into law on November 12, 1999. This bill is primarily known as the bill which brought long-awaited financial service modernization. However, the law also contained privacy protections for consumers and customers of entities providing financial services and products. As we all know, "information" is a commodity which is bought and sold just as other commodities are.

This act required various regulators to release their regulations within 6 months. This was later changed to 12 months. The Board of Governors of the Federal Reserve System released its Regulation P on June 6, 2000.

The Graham-Leach-Bliley Act of 1999 was enacted with the express intent that a financial institution should be limited in its ability to transfer or sell certain information about its customers and potential customers to other third parties. Consequently, under the new law, a customer or potential customers, in certain situations, will be able to prevent a financial institution from sharing information about himself or herself.

A financial institution serving as an IRA custodian/trustee will need to comply with the privacy rules.

An IRA accountholder is a customer for purposes of this law. However, a financial institution should also be aware that it will violate, in most situations, the prohibited transaction rules if it releases, via a sale, IRA accountholder information without the accountholder's consent. Individuals who participate in qualified plans, SEP-IRAs or SIMPLE IRAs are not consumers as defined in the Graham-Leach-Bliley Act of 1999 because these accounts are "business-type" accounts.

The purpose of this article is to discuss in detail the new privacy rules. This article is based on Regulation P as issued by the Federal Reserve Board of Governors. Hereinafter the term "you" is used to describe any financial institution required to comply with Regulation P.

EFFECTIVE DATE(S).

Regulation P is effective November 13, 2000, but you will not be required to comply until July 1, 2001. You must provide an initial notice to all of your customers by July 1, 2001.

Regulation P applies to U.S. offices of entities for which the Board has primary supervisory authority.

The regulations of other regulators should be virtually identical. The other regulators are: (1) the Office of the Comptroller of the Currency; (2) The Board of Directors of the Federal Deposit Insurance Corporation; (3) The Director of the Office of Thrift Supervision; (4) The National Credit Union Administration Board; and (5) The Securities and Exchange Commission.

GENERAL PROHIBITION.

Although the approach of this federal law is generally one of disclosure and then giving the consumer the right to instruct to not have information about him or her disclosed, there is a general prohibition on disclosure of certain account numbers. You must not, directly or through an affiliate, disclose, other than to a consumer reporting agency, an account number or similar form of access number or access code for a consumer's credit card account, deposit account, or transaction account to any nonaffiliated third party for use in telemarketing, direct mail marketing or other market-

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ing through electronic mail to the consumer. Note that other nonmarketing uses are permissible.

This prohibition clearly applies to IRA account numbers.

There is, of course, an exception which permits disclosure of an account number or similar number in some situations: (1) to your agent or service provider solely in order to perform marketing for your own products and services as long as the agent or service provider is not authorized to directly initiate charges to the account; or (2) to a participant in a private label credit card program or an affinity or similar program where the participants in the program are identified to the customer when the customer enters into the program.

THE LAW'S GENERAL APPROACH

A financial institution will be required to perform the following three tasks:

1. Provide a notice to its customers and consumers defining its privacy policies and practices;

2. Describe the conditions under which a financial institution will be permitted to disclose nonpublic information about consumers to nonaffiliated third parties; and

3. Provide a method for consumers to instruct the financial institution that they do not want certain information disclosed.

DEVELOP YOUR PRIVACY POLICIES AND PRACTICES.

This is implied as a precondition to the notice requirement. It is impossible to furnish a notice on nonexistent policies and procedures. You must define your policies and procedures.

Privacy and practice procedures apply only to nonpublic personal information about individuals who obtain financial products or services primarily for personal, family or household purposes. It does not apply to information about companies or individuals who obtain financial products or services for business, commercial, or agricultural purposes.

Obviously, nonpublic personal information does not include all sources or types of information. To be nonpublic personal information it must be personal identifiable financial information or any list that is derived using any personally identifiable financial information that is not publicly available. Personally identifiable financial information means any information a consumer provides to you to obtain a financial product or service from you; about a consumer resulting from any transaction between you and a consumer; and you otherwise obtain about a consumer in connection with providing a product or service to that consumer.

Personally identifiable financial information does not include a list of names and addresses of customers of an entity that is not a financial institution, nor information that does not identify a customer.

Nonpublic personal information cannot arise from publicly available information. You have a reasonable basis to believe that certain information is lawfully made available to the general public from: (i) governmental records; (ii) widely distributed media; and (iii) disclosures to the general public that are required to be made by Federal, state, or local law.

FURNISH THE INITIAL NOTICE.

You must provide a clear and conspicuous notice that accurately reflects your privacy policies and practices to: (1) any customer and (2) any consumer.

You must furnish your notice to a customer not later than when you establish the customer relationship, unless an exception allowing for later delivery applies. You establish a customer relationship when you and a consumer enter into a continuing relationship. When an individual executes an IRA plan agreement, he or she is clearly entering into a continuing customer relationship. You may provide the initial notice within a reasonable time after the customer relationship is established if: (1) establishing the customer relationship is not at the customer's election (e.g. you buy a branch of another institution) or (2) there would be a substantial delay in fulfilling the customer's transaction if the notice had to be provided upon establishment, but only if the customer agrees to receiving the notice at a later time.

Once an individual is a customer, you may or may not have a need to furnish a new or additional privacy notice when he/she obtains a new financial product or service. If you have previously furnished a complying notice which was accurate with respect to the new product or service, then a subsequent notice is not required. Otherwise, you will need to comply by furnishing a revised privacy notice.

You must furnish your notice to a consumer before you disclose any nonpublic personal information about the consumer to any nonaffiliated third party (other than under a legally permissible exception) and you do not have a customer relationship. Thus, you do not need to provide an initial notice to a consumer if you do not disclose any nonpublic personal information about the consumer other than as permitted by law.

A consumer is an individual who applies for, obtains, or has obtained, a financial product or service from you that is to be used primarily for personal, family, and household purposes, or by that individual's legal representative.

FURNISH THE ANNUAL NOTICE.

You must provide a clear and conspicuous notice to your customers that accurately reflects your privacy policies and practices not less than once in any period of 12 consecutive months. You may define this 12 consecutive twelve-month period in any manner, but you must apply it to the customer on a consistent basis. Possible 12-month periods are: (1) the calendar year; (2) the fiscal year of the

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financial institution; or
(3) the year commencing with when the customer relationship is first established. For example, if you elect to use the calendar year as your annual period and a customer becomes a customer on 1-25-01, then you will not need to provide the annual notice for 2002 (i.e. the second annual period) until — 12-31-2002. Of course, you could furnish it earlier if you wished. Your duty to furnish an annual notice ceases when a customer becomes a former customer.

FURNISH A REVISED PRIVACY NOTICE WHEN REQUIRED.

From time to time a financial institution may choose to change its privacy policies as stated in the initial notice. The following rules cover this situation. You must not disclose any nonpublic personal information unless you meet these four requirements: (1) provide a revised notice that accurately reflects the new policies; (2) provide an "opt out" notice; (3) give reasonable time to opt out; and (4) the consumer does not opt out.

There is no limit to the number of times a financial institution may modify its privacy policies. A revised notice is not required if the last notice received by a consumer accurately described a new category or a new nonaffiliated third party.

Unless an exception applies, you must provide a revised notice before you: (1) disclose nonpublic personal information about a former customer to a nonaffiliated third party if that former customer has not had the opportunity to exercise his or her opt out right; (2) disclose a new category of nonpublic personal information or (3) disclose a new category of nonaffiliated third party(ies).

THE CONTENT REQUIREMENTS FOR THE PRIVACY NOTICE.

You must include each of the following items:

1. The categories of nonpublic information which you collect;
2. The categories of nonpublic information which you disclose;
3. The categories of affiliates and nonaffiliated third parties to whom you disclose nonpublic information;
4. The categories of nonpublic personal information about your former customers that you disclose and the categories of affiliates and nonaffiliated third parties to whom you disclose such information;
5. If you disclose nonpublic personal information to a nonaffiliated third party under section 216.13, a separate statement of the categories of information you disclose and the categories of third parties with whom you have contracted;
6. An explanation of the consumer's right to opt out of the disclosure on nonpublic personal information to nonaffiliated third parties, including the method(s) by which the consumer may exercise that right at any time;
7. Your policies and practices with respect to protecting the confidentiality and security of the nonpublic information; and
8. Any disclosure you make under the following rule. If you disclose nonpublic personal information to third parties because of an exception for joint servicing or marketing, then you are only required to state that you make disclosures to other nonaffiliated third parties as permitted by law.

ACCEPTABLE FORM FOR DELIVERING THE PRIVACY AND OPT OUT NOTICE

You may satisfy the initial notice requirement by providing a short-form initial notice at the same time as you deliver an opt out notice.

The short form initial notice must: (i) be clear and conspicuous; (ii) state that your notice is available upon request,and (iii) explain a reasonable means by which the consumer may obtain that notice.

THE FORMAT OF DELIVERING THE PRIVACY AND OPT OUT NOTICES

You must do so in such a way that you may reasonably expect that a consumer will receive actual notice in writing. Therefore, an oral notice furnished in person or over the phone is never sufficient. For example, you may hand-deliver a printed copy of the notice to the consumer or mail a printed copy to the consumer's last known address. The notice may be furnished electronically if the consumer agrees and if you require the consumer to acknowledge receipt of the notice as a necessary step to obtaining the particular financial product or service.

You will not be in compliance if you only post a sign or generally publish advertisements describing your privacy policies and practices. Nor will you be in compliance if you send the notice via electronic mail to a consumer who has not obtained a product or service from you electronically (i.e. is your electronic customer).

However, the rules are substantially less strict for furnishing the annual notice. You are deemed to have given reasonable notice even in some situations when you have not furnished it. You are deemed to have given the notice if: (1) the customer has requested that you not send any information regarding the relationship and your current privacy notice remains available to the customer upon request; or (2) the customer uses your web site to access financial products and services electronically (note there is no requirement to be an electronic customer) and agrees to receive notices at the web site, and you post your current privacy notice continuously in a clear and conspicuous manner on the web site.

CONDITIONS PREREQUISITE TO DISCLOSING NONPUBLIC PERSONAL INFORMATION

You may not directly or through any affiliate disclose any nonpublic information about a consumer to a non-

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affiliated third party unless: (1) you have provided the consumer with the initial notice: (2) you have provided the consumer with the opt out notice; (3) you have given the consumer a reasonable opportunity to opt out before you disclose such information; and (4) the consumer does not opt out. However, there is a major exception for service providers and joint marketing arrangements.

You will be found to have given the consumer a reasonable opportunity to opt out in the following situations. First, if you mailed the notice and then allow the consumer to opt out by mailing a form to you, calling a toll-free number, or any other reasonable means within 30 days from the date you mailed the notice. Second, if the consumer has agreed to accept the notice electronically and you then allow the consumer to opt out by any reasonable means within 30 days from the date the customer acknowledged receipt of the notice. Mailed the notice.

However, there are two major statutory exceptions.

Exception #1. The first exception is partial and is for service providers and joint marketing arrangements. You may provide nonpublic personal information to a nonaffiliated third party to perform services for you or functions on your behalf without having to comply with the opt out rules as discussed above if you provide the initial notice and you enter into a contractual agreement with the third party that prohibits the third party from disclosing or using the information other than to carry out the indicated task.

You have until July 1, 2002, to modify your contracts with third-party service providers, even if such contract does not contain a provision requiring the third party to maintain confidentiality of nonpublic personal information, as long as you entered into such contract before July 1, 2000.

Exception #2. The second exception is very broad and most institutions may wish to structure transactions so that it will apply. The initial notice requirement, the opt out rule, and the special rules for service providers and joint marketing do NOT apply if you disclose nonpublic information for the following reasons:

1. As necessary to effect, administer, or enforce a transaction which a consumer requests;

2. As necessary to effect, administer, or enforce a transaction which a consumer authorizes; Query: Are there any transactions which a consumer does not request or authorize?

3. In connection with servicing or processing a financial product or service that a consumer requests or authorizes; and

4. In connection with maintaining or servicing the consumer's account with you.

Necessary to effect, administer, or enforce a transaction means the disclosure is required, or is one of the lawful or appropriate methods, to enforce your rights or the rights of other persons engaged in carrying out the financial transaction or providing the product or service.

Necessary to effect, administer, or enforce a transaction also means the disclosure is required, or is a usual, appropriate, or acceptable method:

1. To carry out the transaction or the product or a service business of which the transaction is a part, and record, service, or maintain the consumer's account in the ordinary course of providing the financial service or financial product;

2. To administer or service benefits or claims relating to the transaction or the product or service business of which it is a part;

3. To provide a confirmation, statement or other record of the transaction, or information on the status or value of the financial service or financial product to the consumer or the consumer's agent or broker;

4. To accrue or recognize incentives or bonuses associated with the transaction that are provided by you or any other party;

5. To underwrite insurance at the consumer's request, or for reinsurance purposes, or for any of the following purposes as they relate to a consumer's insurance: account administration, reporting, investigating, or preventing fraud or material misrepresentation, processing premium payments, processing insurance claims, administering insurance benefits, participating in research projects, or as otherwise required or specifically permitted by Federal or State law; or

6. In connection with:

a. the authorization, settlement, billing, processing, clearing, transferring, reconciling, or collection of amounts charged, debited, or otherwise paid using a debit, credit or payment card, check, or account number, or by other payment means;

b. The transfer of receivables, accounts or interest therein; or

c. The audit of debit, credit, or other payment information.

In addition to the initial notice requirement, the opt out rule and the special rules for service providers and joint marketing do NOT apply if you disclose nonpublic information for the following reasons:

1. With the consent or at the direction of the consumer, provided that the consumer has not revoked the consent or direction;

2. To protect the confidentiality or security of your records pertaining to the consumer, service, product, or transaction;

3. To protect against or prevent actual or potential fraud, unauthorized transactions, claims, or other liability;

4. For required institutional risk control, or for resolving consumer disputes or inquiries;

5. To persons holding a legal or beneficial interest relating to the consumer; or

6. To persons acting in a fiduciary capacity on behalf of the consumer;

7. To provide information to insurance rate advisory organizations, guaranty funds or agencies, agencies

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that are rating you, persons that are assessing your compliance with industry standards, and your attorneys, accountants and auditors;

8. To the extent specifically permitted or required under other provisions of law and in accordance with the Right to Financial Privacy Act of 1978, to law enforcement agencies, the Secretary of the Treasury, a state insurance authority with respect to any person domiciled in that insurance authority's state that is engaged in providing insurance, the Federal Trade Commission, self-regulatory organizations, or for an investigation on a matter related to public safety.

9. To a consumer reporting agency in accordance with the Fair Credit Reporting Act, or

10. From a consumer report reported by a consumer reporting agency;

11. In connection with a proposed or actual sale, merger, transfer, or exchange of all or a portion of a business or operating unit if the disclosure of nonpublic personal information concerns solely consumers of a business or unit;

12. To comply with Federal, State, or local laws, rules, and other applicable legal requirements;

13. To comply with a properly authorized civil, criminal, or regulatory investigation, or subpoena or summons by Federal, State or local authorities; or

14. To respond to judicial process or government regulatory authorities having jurisdiction over you for examination, compliance, or other purposes as authorized by law.

The PRESENTATION Requirements of the Privacy Notice For a Customer.

It must be clear and conspicuous and accurately reflect an institution's privacy policies and procedures. To be clear and conspicuous means that a notice is reasonably understandable and designed to call attention to the nature and significance of the information in the notice.

Your notice will be reasonably understandable if you use clear, concise sentences, paragraphs, and sections; use short explanatory sentences or bullet lists whenever possible; use definite, concrete, everyday words in the active voice whenever possible; avoid multiple negatives; avoid legal and highly technical business terms whenever possible; and use precise explanations.

Your notice will be found to call attention as needed if you use a plain-language heading to call attention to the notice; use a typeface and type size that are easy to read; provide wide margins and ample line spacing; use boldface or italics for key words; and use distinctive devices when you combine your notice with other information.

LIMITS ON YOUR REDISCLOSURE AND REUSE OF INFORMATION

To whom and what information you may redisclose and reuse depends upon from whom you received it and how you received it.

If you received the information from a nonaffiliate financial institution under an exception, then your may disclose the information to the affiliates of the institution from which you received the information; you may disclose the information to your affiliates, but your affiliates may, in turn, disclose and use the information only to the extent that you could; and you may disclose the information pursuant to any other exception in the ordinary course of business to carry out the activity covered by the exception under which you received the information.

If you received the information from a nonaffiliated financial institution other than by use of an exception, then you may disclose the information only to the affiliates of the institution from which you received the information; you may disclose the information to your affiliates, but your affiliates may, in turn, disclose and use the information only to the extent that you could; and to any other person, if the disclosure would be lawful if made directly to that person by the financial institution from which you received the information.

LIMITS ON A NONAFFILIATED THIRD PARTY'S ABILITY TO REDISCLOSE AND REUSE INFORMATION

If you disclose nonpublic personal information to a nonaffiliated third party under an exception, then the third party may disclose the information to your affiliates; the third party may disclose the information to its affiliates, but its affiliates may, in turn, disclose and use the information only to the extent that the third party could; and the third party may disclose and use the information pursuant to any other exception in the ordinary course of business to carry out the activity covered by the exception under which it received the information.

If you disclose nonpublic personal information to a nonaffiliated third party other than under an exception, then the third party may disclose the information to your affiliates; the third party may disclose the information to its affiliates, but its affiliates may, in turn, disclose and use the information only to the extent that the third party could; and to any other person, if the disclosure would be lawful if you made it directly to that person.

RELATION TO STATE LAWS.

The individual will be entitled to the greatest protection provided by law whether that be federal law or state law. This law shall not be construed as superseding, altering, or affecting any statute, regulation, order, or interpretation in effect in any State except to the extent that such statute, regulation, or order is inconsistent with this law, and then only to the extent of the inconsistency. ◆

THE FIRST-TIME HOMEBUYER EXCEPTION

Using IRAs (traditional and Roth) to accumulate funds to be used to buy a house is a financial planning tool which should be marketed more than it is. More financial institutions should be trying to sell (i.e. encourage to establish) Roth IRAs and traditional IRAs to people who otherwise might not want a "retirement" IRA or Roth IRA. The primary purpose of their IRA is not retirement, it is to accumulate a down payment for a house.

In the case of a traditional IRA, funds withdrawn to buy a first-time home will need to be included in income (i.e. taxed), but the 10% additional tax will not be assessed even though the accountholder is younger than 59 1/2. In the case of a Roth IRA, funds withdrawn to buy a house will neither be taxed nor subject to the 10% additional tax as long as the five-year withholding requirement has been satisfied.

Set forth below is a summary of the rules which apply as taken from the 1999 IRS Publication 590. The term "you" refers to the IRA accountholder/taxpayer.

Even if you are under age 59 1/2, you do not have to pay the 10% additional tax on amounts you withdraw to buy, build, or rebuild a first home. To qualify for treatment as a first-time homebuyer distribution, the distribution must meet ***all*** the following requirements.

1) It must be used to pay qualified acquisition costs (defined later) before the close of the 120th day after the day you received it.

2) It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer (defined later) who is any of the following.

a) Yourself.
b) Your spouse
c) Your or your spouse's child
d) Your or your spouse's grandchild
e) Your or your spouse's parent or other ancestor.

3) When added to all your prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000.

TIP: If both you and your spouse are first-time homebuyers (defined later), each of you can withdraw up to $10,000 for a first home without having to pay the 10% additional tax.

Qualified acquisition costs. Qualified acquisition costs include the following items.

1) Costs of buying, building, or rebuilding a home.

2) Any unusual or reasonable settlement, financing, or other closing costs.

First-time homebuyer. Generally, you are a first-time home buyer if you had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, or build, or rebuild. If you are married, your spouse must also meet this no-ownership requirement.

Date of acquisition. The date of acquisition is the date that:

1) You enter into a binding contract to buy the main home for which the distribution is being used or,

2) The building or rebuilding of the main home for which the distribution is being used begins.

IRA ARTICLES IN NEWSPAPERS

It is a buyer-beware and reader-beware world. Unfortunately this is true for IRA articles as well as it is for most other subjects. Sometimes by trying to "simplify" a subject, the writer just becomes wrong in what he or she says.

We recently were sent an article to review by an employee of a financial institution. We sent the following response.

I have reviewed the "Your Money" article by Nancy Dunnan. The article is not written as clearly as one would hope.

Ms. Dunnan's concept is - a person submits a question of general interest and then Ms. Dunnan writes a response. The person submitting the question may cause "some problems" because, as is often the case, if a person could state his or her question exactly the way it should be posed, then he or she probably would not need to ask the question.

In the "Wrong Choice for an IRA" question, W.R. of Grosse Pointe, Michigan in posing his question was trying to illustrate what he thought to be true – an IRA is a better investment vehicle than a general annuity because a recipient of distributions from a general annuity (Code section 72) is taxed at the "regular" income tax rates whereas a recipient of distributions from an IRA is taxed at the more favorable capital gains rates. Thus, he wanted some confirmation or explanation that he had not done the right thing by buying the annuity.

In answering his question, Ms. Dunnan should have made it absolutely clear that a distribution from an IRA (to the extent it must be included in income) is ALWAYS taxed at the "regular income tax rates" and never at the capital gains rates.

She did a good job of explaining the general rule, "… all withdrawals from an IRA originally funded with pretax dollars are treated as ordinary income in the year received." She erred, however, when she stated or implied that capital gain treatment would apply if he had made nondeductible contributions. As you know, this is wrong. The fact a person makes nondeductible contributions does not entitle that person to capital gain treatment when distributions occur.

As you also no doubt observed, Nancy Dunnan did not discuss very well whether or not his purchase of the IRA annuity had been a good investment. It was not clear to me that the IRA annuity had been the "wrong choice."

The purpose of her column is apparently to give more general information than specific. In addition, it would have been helpful for her to make the point that the rules governing general annuities are different from those governing IRAs and IRA annuities.◆

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Claiming a Deduction for a Loss Within a Roth IRA — Permissible or Not?

We have reprinted a letter which we wrote on whether or not a taxpayer is authorized to claim a deduction for a loss which occurs within a Roth IRA. It appears the law is not settled and that the IRS, hopefully, will furnish more guidance.

September 12, 2000

Dear Roth IRA Accountholder:

You called with the following situation. Early in 2000 you contributed $2,000 to a Roth IRA. You have realized substantial gains with respect to some non-IRA investments, and you will not be eligible to make a Roth IRA contribution. You also indicated that the $2,000 contribution to the Roth IRA was invested in an investment which depreciated approximately 75%. As you know, the Roth contribution is an excess contribution and must be withdrawn along with the related earnings or losses. You asked if you would be able to somehow withdraw the current FMV or be distributed the Roth IRA investment in kind, and be permitted to use the $1,500 depreciation in FMV on your personal tax return.

I find your situation to be very interesting. As my discussion will indicate, the amount of IRS authority is limited. The law is well settled in that a deduction from income is permissible only when expressly authorized by law.

I believe there are a number of Code sections which should be considered. There are the IRA Code sections: 408, 219, and 72. There is section 165 setting forth the rules for losses. There is section 67 setting the 2% floor on miscellaneous itemized deductions. And there are sections 1211 and 1212 which set forth the rules for losses from sales or exchanges of capital assets.

I have enclosed page 29 of the 1999 IRS Publication 590. This provides a short discussion on recognizing losses on IRA investments. I have also sent a copy Question and Answer D6 of IRS Notice 87-16. I believe, in this Notice, the IRS discussed for the first time in what situation a loss from an IRA may be recognized.

With respect to losses on traditional IRA investments, the IRS states the rule as follows. The taxpayer can recognize a loss on their income tax return, but only when (1) all amounts from the traditional IRA have been distributed to the person, and (2) the total distribution is less than the unrecovered basis, if any. In the case of a traditional IRA, the basis is the total amount of nondeductible contributions as modified by previous distributions. The taxpayer is allowed to claim the loss as a miscellaneous itemized deduction subject to the 2% adjusted gross income limit. The IRS reached the conclusion that Code section 165(c)(2) applies to traditional IRAs in some situations. Code section 165(c)(2) authorizes a deduction when an individual “suffers a loss incurred in any transaction entered into for profit, though not connected with a trade or business.”

The IRS furnished an example. My summary—In 1998, an individual contributed $2,000 to a traditional IRA (the total amount is a nondeductible contribution); thus the basis is $2,000. The individual had no other IRAs prior to this contribution. Interest posted to the account in 1998 and 1999 totaled $400, increasing the balance to $2,400. The individual then withdraws $600, of which $500 is the return of basis, and $100 is interest. The value at the end of 1999 is $1,800 (basis of $1,500 and earnings of $300). In 2000, the $1,800 decreases to $1,300 as the IRA investments perform poorly and lose $500. The taxpayer elects to withdraw the entire $1,300 balance. He will be eligible to claim a tax deduction of $200 since his basis of $1,500 exceeds by $200 the amount distributed of $1,300. Note that under this approach, all decreases in the value are first allocated to the non-basis items and then are allocated to basis only when all income has been offset.

My first observation is that the IRS discussion and example applies only to losses with respect to traditional IRA investments. I have not seen the IRS address in the Publication 590 or any other written source, the concept of recognizing losses on Roth IRA investments. I do not know if this has been intentional or not.

My guess is that the IRS will ultimately adopt the position that the above rule will be expanded to apply to Roth IRAs as well as traditional IRAs. That is, a taxpayer will be able to claim a loss within his or her Roth IRA or traditional IRA as a miscellaneous deduction subject to the 2% adjusted gross income as long as the two conditions are satisfied: (1) all amounts within the traditional IRA or Roth IRA must have been distributed, and (2) the total distribution is less than the unrecovered basis, if any.

There may be some interesting planning issues since the Roth IRA rules specify the order of distributions from a Roth IRA for income tax purposes to be: (1) regular contributions which are basis come out first; (2) conversion contributions which are also basis come out second; and then (3) aggregate earnings from all years, if any. Thus, it appears a Roth IRA accountholder will be entitled to claim a deduction with respect to his or her Roth IRA only when the aggregate earnings and losses become a net loss and he or she then elects to take a total distribution.

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My second observation is that the IRS example does not cover making a contribution early in the year and then withdrawing it later in the same year. Assume an individual made a contribution or $2,000 to a traditional IRA or a Roth IRA on 3/1/2000. The investment performs poorly, and is only worth $500 when withdrawn in 2000. Will the individual be entitled to somehow use the $1,500 loss on his 2000 tax return? This is your situation.

Again, I have not seen the IRS expressly address this "current-year situation." Although the rules for withdrawal of a current-year/excess contribution provide that such a withdrawal is not subject to tax if certain rules are met, such rules do not expressly state that the individual will be treated as not having made an IRA contribution. In fact, under the current law (Code section 408(d)(4)), it is settled that the income, if any, is taxed as a distribution from an IRA and is subject to the 10% pre-age 59 1/2 tax unless an exception would apply. Consequently, such income is not entitled to capital gain treatment, as it is being distributed from an IRA.

I do see it as being very possible that the IRS will adopt an approach which will allow a partial deduction of the loss in the first contribution year situation for either a traditional IRA or Roth IRA. Clearly, a person, when he or she contributes to a traditional IRA or Roth IRA has the intent to gain a "profit."

In summary, I would suggest that you, as the taxpayer, should complete your 2000 Federal tax return on the basis that the IRS will agree that it is permissible for a taxpayer to claim a loss as a miscellaneous deduction subject to the 2% adjusted gross income limit. You should attach a special memorandum informing the IRS of this issue. This will require the IRS to make a decision, at least with respect to you. You can see what they say. Best of luck. If you are willing, I would appreciate being updated on this situation.

Sincerely,
James M. Carlson
Senior Vice President/Attorney

1999 Publication 590

Recognizing Losses on IRA Investments

If you have a loss on your traditional IRA investment, you can recognize the loss on your income tax return, but only when all the amounts in all your traditional IRA accounts have been distributed to you and the total distributions are less than your unrecovered basis, if any. Your basis is the total amount of the nondeductible contributions in your traditional IRAs. You claim the loss as a miscellaneous itemized deduction, subject to the 2% limit, on Schedule A, Form 1040.

Example. Bill King has made nondeductible contributions to a traditional IRA totaling $2,000, giving him a basis at the end of 1998 of $2,000. By the end of 1999, his IRA earns $400 in interest income. In that year, Bill withdraws $600 ($500 basis + $100 interest), reducing the value of his IRA to $1,800 ($2,000 + 400 - 600) at year's end. Bill figures the taxable part of the distribution and his remaining basis on Form 8606 (illustrated in *Appendix D)*.

In 2000, Bill's IRA has a ***loss*** of $500. At the end of that year, Bill's IRA balance is $1,300 ($1,800 - 500). Bill's remaining basis in his IRA is $1,500 ($2,000 - 500). Bill withdraws the $1,300 balance remaining in the IRA. He can claim a loss for 2000 of $200 (the $1,500 basis minus the $1,300 withdrawn IRA balance). Bill completes Form 8606 as illustrated in *Appendix D.*

Question & Answer D6 (from Notice 87-16)

D6: In what circumstances does an individual recognize a loss from an IRA?

A: A loss from an IRA may be recognized only when all amounts have been distributed and the amounts distributed are less than the individual's unrecovered basis. For example:

An individual makes contributions totalling $10,000, all nondeductible, to an IRA. The IRA earns $4,000 over the course of the five years. Distributions commence at the end of the fifth year, and the individual removes $6,000. The nontaxable portion (return of basis) equals

$$\frac{\$10{,}000}{\$14{,}000} \times \$6{,}000 = \$4{,}285.71$$

The remaining balance is: $14,000 - $6,000 = $8,000

The remaining basis is: $10,000 - $4,285.71 = $57,14.29

In the next year, the IRA sustains a loss of $5,000. The account balance as of the end of the year is $3,000, which is less than the remaining basis. If the individual withdraws the entire $3,000, no pro rata calculation is necessary and the individual may claim a loss of $2,714.29. If the taxpayer withdraws less than the entire balance, the pro rata calculation is necessary. ◆