

MEMO# 16035

May 9, 2003

IRS ISSUES FINAL REGULATIONS ON EARNINGS CALCULATIONS FOR EXCESS IRA CONTRIBUTIONS

[16035] May 9, 2003 TO: PENSION MEMBERS No. 21-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 25-03 RE: IRS ISSUES FINAL REGULATIONS ON EARNINGS CALCULATIONS FOR EXCESS IRA CONTRIBUTIONS The Internal Revenue Service recently issued final regulations on the calculation of net income attributable to IRA contributions that are distributed as returned contributions under Code section 408(d)(4) or recharacterized under Code section 408A(d)(6). The final regulations, which set forth the “new method” of calculation provided in Notice 2000-39,¹ adopt the rules provided in the proposed regulations² without modification. As in the case of the proposed regulations, the final rules reflect comments submitted by the Institute in response to Notice 2000-39.³ New Method for Net Income Calculation under Section 408(d)(4). The final regulations provide that for purposes of returned contributions under section 408(d)(4), the net income attributable to an IRA contribution is determined by allocating to the contribution a pro rata portion of the net income on the assets in the IRA (whether positive or negative) during the period the IRA held the contribution. The new method is represented by the formula:
$$\text{Net Income} = \frac{\text{Contribution} \times (\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$
 The adjusted opening balance is the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is distributed as a returned contribution under section 408(d)(4) and 1 See Institute Memorandum to Pension Committee No. 47-00, Pension Operations Advisory Committee No. 49-00 and Ad Hoc Committee on Roth IRAs, dated July 12, 2000. 2 See Institute Memorandum to Pension Committee No. 29-02 and Pension Operations Advisory Committee No. 49-02, dated July 24, 2002. 3 See Institute Memorandum to Pension Committee No. 60-00, Pension Operations Advisory Committee No. 61-00 and Ad Hoc Committee on Roth IRAs, dated August 24, 2000. Notably, consistent with the Institute’s comments, the final regulations provide that a single computation period should be used if more than one contribution was made to the IRA as a regular contribution. 2 recharacterizations of contributions under section 408A(d)(6)) made to the IRA during the computation period. The adjusted closing balance is the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including recharacterizations of contributions under section 408A(d)(6)) made from the IRA during the computation period. The term “computation period” is defined as the period beginning immediately prior to the time that the contribution being returned was made to the IRA and ending immediately prior to the removal of the contribution. If more than one contribution was made as a regular contribution⁴ and is being returned from the IRA, the computation period begins immediately prior to the time the first contribution being returned was

contributed. Additionally, where an IRA has received more than one regular contribution for a taxable year, the last regular contribution made to the IRA for the year is deemed to be the contribution that is distributed as a returned contribution under section 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution. In the case of an individual with multiple IRAs, the net income calculation is performed only on the IRA containing the contribution being returned, and that particular IRA must distribute the contribution. The final regulations provide that a transfer made in or out of an IRA during the computation period is treated in the same manner as a contribution or distribution made to or from the IRA. A special rule is also provided where an IRA asset is not normally valued on a daily basis. Examples that illustrate the new method of calculation are provided (including the calculation of net income with regard to multiple contributions made to an IRA). New Method for Net Income Calculation Under Section 408A(d)(6). For recharacterizations under section 408A(d)(6), the final rules for calculating net income are substantially similar to calculations under section 408(d)(4). If more than one contribution is being recharacterized, however, the IRA owner may choose (by date and dollar amount, rather than by specific assets acquired with those dollars) which contribution is to be recharacterized.⁵ If a series of regular contributions were made and consecutive contributions in that series are being recharacterized, the computation period is determined using a single computation period based on the first contribution in the series. ⁴ The term “regular contribution” is defined as an IRA contribution made by the IRA owner that is neither a trustee- to-trustee transfer from another IRA nor a rollover from another IRA or retirement plan. ⁵ The preamble to the final regulations emphasizes that once contributions are commingled in an account, those dollars are no longer associated with particular assets or contributions. Net income calculations and allocations, therefore, must be based on the overall value of the IRA and the amounts contributed, distributed or recharacterized to or from the IRA. Accordingly, even with the recharacterization of amounts converted to a Roth IRA where the Roth IRA contains both regular and conversion contributions, the final regulations do not allow net income, including any losses, to be allocated other than pro rata. ³ Effective Date. The final regulations are effective May 5, 2003, but apply to calculations of income allocable to IRA contributions made on or after January 1, 2004. For purposes of determining net income for IRA contributions made in 2002 and 2003, taxpayers may continue to apply the rules set forth in Notice 2000-39 or may rely on the proposed regulations. Thomas T. Kim Associate Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 16035, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16035. Attachment (in .pdf format)