

MEMO# 14958

July 24, 2002

IRS ISSUES PROPOSED REGULATIONS ON EARNINGS CALCULATIONS FOR EXCESS IRA CONTRIBUTIONS

[14958] July 24, 2002 TO: PENSION COMMITTEE No. 29-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 49-02 RE: IRS ISSUES PROPOSED REGULATIONS ON EARNINGS CALCULATIONS FOR EXCESS IRA CONTRIBUTIONS The Internal Revenue Service recently issued proposed regulations on the calculation of net income attributable to IRA contributions that are distributed as a returned contribution under Code section 408(d)(4) or recharacterized under Code section 408A(d)(6). The proposed regulations incorporate, with certain modifications, the "new method" of calculation provided in Notice 2000-39.1 As you may recall, the Institute had submitted a comment letter in response to the Notice in August 2000.2 Notably, the proposed regulations provide that a single computation period should be used if more than one contribution was made to the IRA as a regular contribution. With regard to the effective date, the regulations are proposed to be applicable for calculating 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, the proposed regulations provide that taxpayers may continue to apply the rules set forth in Notice 2000-39 or may rely on the proposed regulations. New Method for Net Income Calculation under Section 408(d)(4). Consistent with the guidance in Notice 2000-39, the proposed regulations provide that for purposes of returned contributions under section 408(d)(4), the net income attributable to a 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:
$$\text{Net Income} = \frac{\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$
 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. Notice 2000-39 provided that until further guidance is issued, either the "old method" under Treas. Reg. section 1.408-4(c)(2)(ii) or the "new method" provided in the Notice may be used to calculate net income. 2 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. 2 Net Income = Contribution x (Adjusted Closing Balance - Adjusted Opening Balance) / 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 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. As noted above, if more than one contribution was made as a regular contribution 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. The proposed regulations clarify 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. The proposed regulations contain two examples that illustrate the new method of calculation. In particular, Example 2 under section 1.408-11(d) of the proposed regulations involves the calculation of net income with regard to multiple contributions made to an IRA under the revised definition of computation period. New Method for Net Income Calculation Under Section 408A(d)(6). For recharacterizations under section 408A(d)(6), the rules for calculating net income are substantially similar to the formula above. 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 dollars³ — which contribution is to be recharacterized. Where 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. ³ The proposed regulations provide that net income calculations must be based on the dollar value of the IRA and the amounts contributed, distributed or recharacterized, in contrast to the calculation of earnings on the basis of returns on specific assets. The proposed regulations further note that in the absence of maintaining separate accounts, tying particular assets to a particular contribution would create administrative problems for taxpayers, IRA providers and the IRS. ³ Comments Requested. The IRS has requested comments on the proposed regulations; written or electronic comments must be submitted by October 21, 2002. Please forward any comments you may have on the proposed regulations to the undersigned at (202) 326-5837 or tkim@ici.org. Thomas T. Kim Associate Counsel Attachment (in .pdf format)