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DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-124256-02]

RIN 1545-BA82

Earnings Calculation for Returned or Recharacterized IRA Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations provide a new method to be used for calculating the net income attributable to IRA contributions that are distributed as a returned contribution pursuant to section 408(d)(4) of the Internal Revenue Code or recharacterized pursuant to section 408A(d)(6). The regulations will affect IRA owners and IRA trustees, custodians and issuers.

**DATES:** Written or electronic comments must be received by October 21, 2002.

**ADDRESSES:** Send submissions to: CC:ITA:RU (REG-124256-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-124256-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs).

**FOR FURTHER INFORMATION CONTACT:** Cathy Vohs at 622-6090.

**SUPPLEMENTARY INFORMATION:**

## **Background**

Section 408(d)(4) provides that an IRA contribution will not be included in the IRA owner's gross income when distributed as a returned contribution if: (1) it is received by the IRA owner on or before the day prescribed by law (including extensions) for filing the owner's Federal income tax return for the year of the contribution; (2) no deduction is allowed with respect to the contribution; and (3) the distribution is accompanied by the amount of net income attributable to the contribution.

Section 408A governs Roth IRAs and was added by section 302 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788). Section 408A(d)(6) provides that a contribution made to one type of IRA may be recharacterized as having been made to another type of IRA if: (1) the recharacterization transfer occurs on or before the date prescribed by law (including extensions) for filing the IRA owner's Federal income tax return for the year for which the contribution was made; (2) no deduction is allowed with respect to the contribution to the transferor IRA; and (3) the transfer is accompanied by any net income allocable to the contribution.

Section 1.408-4(c)(2)(ii) of the Income Tax Regulations prescribes the method (the old method) for calculating the amount of net income attributable to a contribution distributed pursuant to section 408(d)(4). The old method bases the calculation of the amount of net income attributable to a contribution on the income earned by the IRA during the period beginning on the first day of the taxable year in which the contribution is made and ending on the date of the distribution from the account. Under the old method, net income cannot be negative.

Section 1.408A-5, A-2(c), provides that if a contribution being recharacterized is in an IRA that at any time contained other contributions, the net income attributable to the contribution being recharacterized is calculated in the manner prescribed by §1.408-4(c)(2)(ii) (the old method), except that net income can be negative. Section 1.408A-5, A-2(b), provides that if an IRA is established with a contribution and no other contributions or distributions are made, then the subsequent recharacterization transfer of the entire account balance of the IRA will satisfy the requirement that the transfer be accompanied by any net income allocable to the contribution.

In connection with issuing the regulations under section 408A governing Roth IRAs, it became apparent that the old method produced anomalous results for contributions made late in the year. This is because, under the old method, account activity in the part of the year that precedes the date the contribution is made is taken into account in the calculation of the net income attributable to the contribution.

In response to this concern, the IRS issued Notice 2000-39 (2000-30 I.R.B. 132), which provided a new method for calculating net income that generally bases the calculation of the amount of net income attributable to a contribution on the actual earnings and losses of the IRA during the time it held the contribution. Under this new method, net income can be negative. Notice 2000-39 provided that until further guidance is issued, either the old method or the new method may be used to calculate net income. Notice 2000-39 also requested comments regarding the new method.

The Service received comments on the new method which were generally favorable. However, commentators provided a number of suggestions for improving the

method, including: (1) allowing a single computation period to be used in the case of multiple IRA contributions; (2) clarifying how transfers in or out of IRAs are treated under the new method; and (3) allowing net income to be determined on the basis of tracing specific assets, rather than dollar amounts. This last suggestion was focused primarily on the calculation of net income in the case of a recharacterization back to a traditional IRA following a conversion of an amount in a traditional IRA to a Roth IRA.

## **Explanation of Provisions**

### New Method for Net Income Calculation Under Section 408(d)(4)

These proposed regulations would incorporate, with certain modifications, the new method provided in Notice 2000-39. Under the proposed regulations, 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. This new method is represented by the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

Under this formula, the opening balance is the fair market value of the IRA immediately before the contribution being returned is made to the account and the closing balance is the fair market value of the account immediately before the contribution is removed. The opening balance then is adjusted to include the amount of any contributions or transfers made to the IRA during the computation period. In addition, the closing balance is adjusted to include the amount of any distributions or transfers made from the

IRA during the computation period. In the case of an IRA that has received more than one regular contribution for a particular 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 response to comments received, the proposed regulations would 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. The proposed regulations also provide that a single computation period is used if more than one contribution was made to the IRA as a regular contribution.

#### New Method for Net Income Calculation Under Section 408A(d)(6)

The proposed regulations would provide rules for calculating net income allocable to a contribution being recharacterized under section 408A(d)(6) that are substantially similar to the rules applicable to contributions being returned under section 408(d)(4). However, if more than one contribution is being recharacterized, different rules apply. In the case of multiple contributions for a particular year that are eligible for recharacterization, the IRA owner chooses (by date and dollar amount, not by specific assets acquired with those dollars) which contribution is to be recharacterized. In addition, if a series of regular contributions was 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.

The proposed regulations would retain the rule that net income calculations must be based on the overall value of an IRA and the dollar amounts contributed, distributed or recharacterized to or from the IRA. Even in a recharacterization of an amount converted to a Roth IRA, the proposed regulations would not permit net income to be calculated on the basis of the return on specific assets. The dollars contributed to an IRA are invested in assets that generate gains and losses. Once contributions are commingled in an account, those dollars are no longer associated with particular assets. 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.

### **Proposed 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 applicable to IRA contributions made during 2002 and 2003, taxpayers may continue to apply the rules set forth in Notice 2000-39 or may rely on these proposed regulations. If, and to the extent, future guidance is more restrictive than these proposed regulations, the future guidance will be issued without retroactive effect.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because proposed §1.408-11 and revised A-2(c) of §1.408A-5 impose no new collection

of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time and place for the hearing will be published in the **Federal Register**.

### **Drafting Information**

The principal author of these regulations is Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

### **List of Subjects 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

§1.408-4 also issued under 26 U.S.C. 408.

§1.408-11 also issued under 26 U.S.C. 408. \* \* \*

Par. 2. Section 1.408-4 is amended by adding the following text before the first sentence of (c)(1):

§1.408-4 Treatment of distributions from individual retirement arrangements.

\* \* \* \* \*

(c) \* \* \*(1) \* \* \*

The rules in this paragraph (c) apply for purposes of determining net income attributable to IRA contributions made before January 1, 2004, and returned pursuant to section 408(d)(4). The rules in §1.408-11 apply for purposes of determining net income attributable to IRA contributions made on or after January 1, 2004, and returned pursuant to section 408(d)(4).

\* \* \* \* \*

Par. 3. Section 1.408-11 is added to read as follows:

§1.408-11 Net income calculation for returned or recharacterized IRA contributions.

(a) Net income calculation for returned IRA contributions--(1) General rule. For purposes of returned contributions under section 408(d)(4), the net income attributable to a contribution made to an IRA is determined by allocating to the contribution a pro-rata



portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

(2) Special rule. If an IRA is established with a contribution and no other contributions, distributions or transfers are made to or from that IRA, then the subsequent distribution of the entire account balance of the IRA pursuant to section 408(d)(4) will satisfy the requirement of that Code section that the return of a contribution be accompanied by the amount of net income attributable to the contribution.

(b) Definitions. For purposes of this section the following definitions apply--

(1) Adjusted opening balance. The term adjusted opening balance means 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 pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made to the IRA during the computation period.

(2) Adjusted closing balance. The term adjusted closing balance means 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 pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(3) Computation period. The term computation period means 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 contribution and is being returned from the IRA, the computation period begins immediately prior to the time the first contribution being returned was contributed.

(4) Regular contribution. The term regular contribution means 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.

(c) Additional rules --(1) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this section, notwithstanding A-3 of §1.408A-5, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(2) In the case of an IRA that has received more than one regular contribution for a particular 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.

(3) In the case of an individual who owns multiple IRAs, the net income calculation is performed only on the IRA containing the contribution being returned, and that IRA is the IRA that must distribute the contribution.

(d) Examples. The following examples illustrate the net income calculation under section 408(d)(4) and this section:

Example 1. (i) On May 1, 2004, when her IRA is worth \$4,800, Taxpayer A makes a \$1,600 regular contribution to her IRA. Taxpayer A requests that \$400 of the May 1, 2004, contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on February 1, 2005, when the IRA is worth \$7,600, the IRA trustee distributes to Taxpayer A the \$400 plus attributable net income. During this time, no other contributions have been made to the IRA and no distributions have been made.

(ii) The adjusted opening balance is \$6,400 [ $\$4,800 + \$1,600$ ] and the adjusted closing balance is \$7,600. Thus, the net income attributable to the \$400 May 1, 2004, contribution is \$75 [ $\$400 \times (\$7,600 - \$6,400) \div \$6,400$ ]. Therefore, the total to be distributed on February 1, 2005, pursuant to § 408(d)(4) is \$475.

Example 2. (i) Beginning in January 2004, Taxpayer B contributes \$300 on the 15th of each month to an IRA for 2004, resulting in an excess regular contribution of \$600 for that year. Taxpayer B requests that the \$600 excess regular contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on March 1, 2005, when the IRA is worth \$16,000, the IRA trustee distributes to Taxpayer B the \$600 plus attributable net income. The excess regular contributions to be returned are deemed to be the last two made in 2004: the \$300 December 15 contribution and the \$300 November 15 contribution. On November 15 the IRA was worth \$11,000 immediately prior to the contribution. No distributions or transfers have been made from the IRA and no contributions or transfers, other than the monthly contributions (including \$300 in January and February 2005), have been made.

(ii) As of the beginning of the computation period (November 15), the adjusted opening balance is \$12,200 [ $\$11,000 + \$300 + \$300 + \$300 + \$300$ ] and the adjusted closing balance is \$16,000. Thus, the net income attributable to the excess regular contributions is \$187 [ $\$600 \times (\$16,000 - \$12,200) \div \$12,200$ ]. Therefore, the total to be distributed as returned contributions on March 1, 2005, to correct the excess regular contribution is \$787 [ $\$600 + \$187$ ].

Par. 4. In §1.408A-5, A-2(c) is revised to read as follows:

§1.408A-5 Recharacterized contributions.

\* \* \* \* \*

A-2. \* \* \*

(c) (1) If paragraph (b) of this A-2 does not apply, then, for purposes of determining net income attributable to IRA contributions, the net income attributable to the amount of a

contribution is determined by allocating to the contribution a pro-rata portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \frac{\text{Contribution} \times (\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

(2) For purposes of this paragraph (c), the following definitions apply--

(i) The term adjusted opening balance means 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 being recharacterized pursuant to section 408A(d)(6) and any other recharacterizations) made to the IRA during the computation period.

(ii) The term adjusted closing balance means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including contributions returned pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(iii) The term computation period means the period beginning immediately prior to the time the particular contribution being recharacterized is made to the IRA and ending immediately prior to the recharacterizing transfer of the contribution. If a series of regular contributions was made to the IRA, and consecutive contributions in that series are being recharacterized, the computation period begins immediately prior to the time the first of the regular contributions being recharacterized was made.

(3) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this paragraph (c), notwithstanding A-3 of this section, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(4) In the case of an individual with multiple IRAs, the net income calculation is performed only on the IRA containing the particular contribution to be recharacterized, and that IRA is the IRA from which the recharacterizing transfer must be made.

(5) In the case of multiple contributions made to an IRA for a particular year that are eligible for recharacterization, the IRA owner can choose (by date and by dollar amount, not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized.

(6) The following examples illustrate the net income calculation under section 408A(d)(6) and this paragraph:

Example 1. (i) On March 1, 2004, when her Roth IRA is worth \$80,000, Taxpayer A makes a \$160,000 conversion contribution to the Roth IRA. Subsequently, Taxpayer A discovers that she was ineligible to make a Roth conversion contribution in 2004 and so she requests that the \$160,000 be recharacterized to a traditional IRA pursuant to section 408A(d)(6). Pursuant to this request, on March 1, 2005, when the IRA is worth \$225,000, the Roth IRA trustee transfers to a traditional IRA the \$160,000 plus allocable net income. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) The adjusted opening balance is \$240,000 [ $\$80,000 + \$160,000$ ] and the adjusted closing balance is \$225,000. Thus the net income allocable to the \$160,000 is - \$10,000 [ $\$160,000 \times (\$225,000 - \$240,000) \div \$240,000$ ]. Therefore, in order to recharacterize the March 1, 2004, \$160,000 conversion contribution on March 1, 2005, the

Roth IRA trustee must transfer from Taxpayer A's Roth IRA to her traditional IRA \$150,000 [\$160,000 - \$10,000].

Example 2. (i) On April 1, 2004, when her traditional IRA is worth \$100,000, Taxpayer B converts the entire amount, consisting of 100 shares of stock in ABC Corp. and 100 shares of stock in XYZ Corp., by transferring the shares to a Roth IRA. At the time of the conversion, the 100 shares of stock in ABC Corp. are worth \$50,000 and the 100 shares of stock in XYZ Corp. are also worth \$50,000. Taxpayer B decides that she would like to recharacterize the ABC Corp. shares back to a traditional IRA. However, B may choose only by dollar amount the contribution or portion thereof that is to be recharacterized. On the date of transfer, November 1, 2004, the 100 shares of stock in ABC Corp. are worth \$40,000 and the 100 shares of stock in XYZ Corp. are worth \$70,000. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) If B requests that \$50,000 (which was the value of the ABC Corp. shares at the time of conversion) be recharacterized, the net income allocable to the \$50,000 is \$5,000 [ $\$50,000 \times (\$110,000 - \$100,000) \div \$100,000$ ]. Therefore, in order to recharacterize \$50,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of \$55,000 [ $\$50,000 + \$5,000$ ].

(iii) If, on the other hand, B requests that \$40,000 (which was the value of the ABC Corp. shares on November 1) be recharacterized, the net income allocable to the \$40,000 is \$4,000 [ $\$40,000 \times (\$110,000 - \$100,000) \div \$100,000$ ]. Therefore, in order to recharacterize \$40,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of \$44,000 [ $\$40,000 + \$4,000$ ].

(iv) Regardless of the amount of the contribution recharacterized, the determination of that amount (or of the net income allocable thereto) is not affected by whether the recharacterization is accomplished by the transfer of shares of ABC Corp. or of shares of XYZ Corp.

(7) This paragraph (c) applies for purposes of determining net income attributable to IRA contributions, made on or after January 1, 2004. For purposes of determining net income attributable to IRA contributions made before January 1, 2004, see paragraph (c) of this A-2 of §1.408A-5 (as it appeared in the April 1, 2003, edition of 26 CFR part 1).

\* \* \* \* \*

David A. Mader  
Acting Deputy Commissioner of Internal Revenue.