Final Regulations for IRA Earnings Calculation—Part 1

EVERY YEAR, SOME TAXPAYERS FACE THE challenge of correcting an excess contribution to their traditional IRA or recharacterizing a Roth IRA contribution or conversion to their traditional IRA. In both situations, the taxpayer must transfer both the contribution (or conversion) amounts and any earnings attributable to that amount. Since the contribution or conversion amounts are known, the taxpayer can easily identify the amounts for transfer. It is the determination of the earnings amounts that presents the challenge.

In the case of a returned contribution, IRC §408(d)(4) provides that an IRA contribution will not be included in the IRA owner's gross income if a few rules are satisfied. That is, if the returned contribution or conversion amount is received by the IRA owner on or before the taxpayer's filing date—including extensions—for the year of the contribution, no deduction is allowed with respect to the contribution, and the distribution is accompanied by the amount of net income attributable to the contribution.

The new method better reflects the earnings attributable to the holding period of the contribution, and it allows the net income amount to be positive or negative.

Background

Prior to the year 2000, the method for calculating the amount of net income attributable to a returned contribution distributed pursuant to §408(d)(4) was prescribed in regulation §1.408-4(c)(2)(ii), or a contribution being recharacterized pursuant to §408A(d)(6) was prescribed in §1.408A-5, Q&A-2(c). In general, the calculation was based on the net income earned by the traditional IRA or Roth 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. This method is referred to as the "old method," and it is discussed in the November 2000 issue of *Strategic Finance*.

The IRS and Treasury Department received comments that the old method has serious flaws. In particular, it doesn't reflect the actual earnings and losses of the IRA during the time the IRA held the contribution because the earnings are based on the first day of the year and not the first day of the contribution. The difference in the investment's holding time can be seen to either inflate or deflate the true earnings attributable to the contribution, depending on the market. Furthermore, the earnings on a returned contribution could not be a negative amount.

Treasury Response

The IRS responded to the comments that were leveled against the old method by proposing a new method on July 24, 2000, which appears in Notice 2000-39 [IRB 2000-30, p. 132], which was followed by Treasury issuing proposed regulations on July 22, 2002, [REG-124256-02, 2002-33 I.R.B., 383 (August 19, 2002)] and, more recently, final regulations on May 2, 2003 [T.D. 9056 (May 2, 2003)]. According to the Notice and regulations, the new method better reflects the earnings attributable to the holding period of the contribution, and it allows the net income amount to be positive or negative. The new method is computed as:

> Net Income = Contribution × [[ACB – AOB] / AOB], where ACB is the fair market value (FMV) of the IRA immediately prior to the distribution (or recharacterization transfer) plus the amount of any distributions made during the computation period, and AOB is the FMV of the IRA immediately prior to the contribution (or conversion) plus the contributions.

To appreciate both methods, see the following examples.

Example 1: Brenda makes a $3,000 contribution to her IRA on July 2nd, which had a FMV of $15,000 on January 1st and $18,000 on July 1st. Brenda learns on November 1st that she will be able to deduct only $2,000 of the contribution. As a result, she requests the trustee to withdraw the $1,000 and its earnings from the IRA on November 1st, when the FMV of the IRA is $24,000. The earnings attributable to the contribution under the old and new calculation methods are $333 ($1,000 x (($24,000 – $18,000) / $18,000)) and $143 ($1,000 × (($24,000 – $21,000) / $21,000)), respectively. By electing the new method, Brenda has a savings of $190 ($333 – $143).

A secondary issue arises in the application of the new method in the case of multiple regular contributions. That is, the taxpayer is required to treat the last regular contribution for a particular taxable year as the first one distributed (and so forth if more than one is returned). The earnings calculation, however, is different under the Notice and the regulations. More specifically, the earnings calculation is performed separately on each returned contribution according to the Notice and is a single calculation from the point of the earliest contribution being returned.

Example 2: Thomas makes a $300 contribution on the 1st of each month to his Roth IRA. On February 5th, Thomas learns that he made an excess contribution of $600 in the prior year and, therefore, requests the $600 (and any earnings) to be returned to him. The FMV of the Roth IRA before the contribution is recorded is $30,000 on January 1st, $52,000 on November 1st, $60,000 on December 1st, and $75,000 prior to the withdrawal. The net income attributable to the two contributions under the Notice is $189 ($69 for December and $123 for November):

> December: $300 × (($75,000 – ($60,000 + $300 + $300 + $300)) / $60,900), and
> November: $300 × (($75,000 – ($52,000 + $300 + $300 + $300 + $300) / $53,200).

Under the regulations, the net income amount is $246 ($600 × (($75,000 – ($52,000 + $300 + $300 + $300 + $300) / $53,200)). The $60,900 equals the $60,000 value on December 1st plus the $300 contributions on December, January, and February, and the $53,200 equals the $52,000 value on November 1st plus the $300 contributions on November, December, January, and February.

The taxpayer can elect to use the old method or the new method that is prescribed in the Notice or in the proposed regulations (which is the same as in the final regulations) for tax years 2002 and 2003. But beginning in year 2004, the new method in the final regulations must be followed.

In Thomas's case, the net income attributable to the excess contributions equals $189 under Notice 2000-39 and is $247 under the proposed and final regulations. If this were a 2003 tax year situation, Thomas would be wise to elect the use of the new method proposed in Notice 2000-39 and claim $189 in interest. If, on the other hand, this were a 2004 tax year situation, Thomas would use the net method proposed in the final regulations and claim $247 in interest. The difference of a year does make a difference for this set of facts.

In next month's column, the new method for calculating earnings under other special taxpayer situations is considered (for example, accounts that are not valued daily and multiple IRAs are examined). ■

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