Final Regulations for IRA Earnings Calculation—Part 2

LAST MONTH, THE NEW METHOD FOR calculating the amount of net income attributable to a returned contribution or a contribution being recharacterized was discussed in light of recently issued final regulations. The general net income formula is based on the net income earned by the traditional or Roth IRA during the period that the returned or recharacterized contribution was held in the IRA. More specifically, the new method for calculating the net income equals the contribution times the value of [[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. Now we turn our attention to the earnings calculation under other special taxpayer situations.

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IRA assets not normally valued on a daily basis

When an IRA asset isn't normally valued on a daily basis, the FMV of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined FMV of the asset. In other words, it is determined as of a date that coincides with or precedes the first day of the computation period. Under this approach, the recharacterized contributions are taken into account for the period (or near period) that they are actually held in a particular IRA solely for purposes of the earnings computation. Consider the following example.

On May 2, 2003, Bob makes a $4,000 contribution to his Roth, which had an FMV of $200,000 on January 1st, $212,000 on April 1st, $232,000 on July 1st, and $240,000 on September 1st. The FMV of Bob's investment fund is reported only at the start of each quarter. Bob learns on August 12th that he made an excess contribution of $1,000 to his Roth IRA, so he elects to have the $1,000 and any interest returned on August 15th. In this case, Bob would use the dates immediately preceding the transactions to calculate the net income amount. More specifically, he would use the April 1st information in determining the AOB and the July 1st information in determining the ACB to calculate the net income attributable to the excess contributions.

Multiple contributions issues

The final regulations retain the rule from the proposed regulations that the net income calculations and allocations 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 where the Roth IRA contains both regular contributions and conversion contributions, the final regulations don't permit net income—including any losses—to be allocated other than pro rata. As a result, the principal amount of regular Roth IRA contributions cannot be protected against adjustment for pro rata share of net income during the computation period, including any net losses. Once contributions are commingled in an account, those dollars are no longer associated with a particular asset or contribution. As noted in the preamble of the final regulations, tying particular assets to a particular contribution would create administrative problems for taxpayers, IRA providers, and the IRS in the absence of maintaining separate accounts.

In the case where an owner makes multiple contributions to an IRA for a particular year that are eligible for recharacterization, the IRA owner can choose (by date and by dollar amount, but not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized. To illustrate this point, the following example, modified from the regulations, is provided.

On April 1, 2004, when Beth's traditional IRA was worth $100,000, she converts the entire amount, consisting of 100 shares of stock in ABC Corporation and 100 shares of stock in XYZ Corporation, by transferring the shares to a Roth IRA. At the time of the conversion, the 100 shares of ABC stock are worth $50,000, and the 100 shares of XYZ stock are also worth $50,000.

A check of the investment records reveals the 100 shares of stock in ABC Corporation are worth $40,000 and the 100 shares of stock in XYZ Corporation are worth $70,000 on November 1, 2004. Furthermore, Beth has made no other contributions to, or distributions from, her Roth IRA. If Beth decides that she would like to recharacterize the ABC Corporation shares back to a traditional IRA on November 1, 2004, then she may choose only by dollar amount the contribution or portion thereof that is to be recharacterized.

Solution 1: If Beth requests that $50,000 (which was the value of the ABC Corporation shares at the time of conversion) be recharacterized, the net income allocable to the $50,000 is $5,000 [$50,000 * ($110,000 - $100,000) / $100,000]. Therefore, in order to recharacterize $50,000 of the April 1, 2004, conversion contributions, the Roth IRA trustee must transfer assets with a value of $55,000 [$50,000 + $5,000] on November 1, 2004.

Solution 2: If Beth requests that $40,000 (which was the value of the ABC Corporation shares on November 1) be recharacterized, the net income allocable to the $40,000 is $4,000 [$40,000 * ($110,000 - $100,000) / $100,000]. In this case, the Roth IRA trustee must transfer assets with a value of $44,000 [$40,000 + $4,000] in order to recharacterize $40,000 of the April 1, 2004, conversion contribution on November 1, 2004.

In both situations, Beth will need to withdraw all the ABC stock and either $15,000 or $5,000 worth of XYZ stock to make up the difference in the recharacterized amount on November 1, 2004. Since the value of the IRA determines the net income, the determination of the recharacterized contribution and net income amount is not affected by whether the recharacterization is accomplished by the transfer of shares of ABC or XYZ Corporation.

Multiple IRAs

Under the regulations, the net income calculation is performed only on the IRA containing the particular contribution to be recharacterized. The individual, therefore, has the opportunity to select the IRA from which the net income calculation will be performed. But in so doing, the recharacterizing transfer is limited to that specific IRA. Remember, if Beth had established a separate Roth IRA for each stock holding, she could have recharacterized the Roth IRA with the ABC stock without making an earning calculation and the need to remove some of her XYZ stock. Thus, a taxpayer can gain an advantage by maintaining multiple IRAs, especially in the case of a conversion contribution. Maybe it is better to have multiple IRAs. ■

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