

## Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under Code sections 408 and 408A. These regulations provide a new method for calculating the net income attributable to IRA contributions that are distributed as a returned contribution pursuant to section 408(d)(4) or recharacterized pursuant to section 408A(d)(6).

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(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.

Notice 2000-39 (2000-2 C.B. 132), provided a new method for calculating net income that generally based 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, and provided that under the new method, net income could be negative. Notice 2000-39 provided that until further guidance is issued, either the old method (*i.e.*, the method specified in § 1.408-4(c)(2)(ii)) or the new method may be used to calculate net income.

Proposed regulations under sections 408 and 408A were published in the **Federal Register** on July 23, 2002 (REG-124256-02, 67 FR 48067). These

proposed regulations incorporated, with certain modifications, the new method provided in Notice 2000-39. The public reaction to Notice 2000-39 was generally favorable and few comments were received on the proposed regulations. Consequently, these final regulations adopt the rules in the proposed regulations without modification.

## Explanation of Provisions

These final regulations retain, without change, the methods provided in the proposed regulations. Thus, under these final regulations, for purposes of returned contributions under section 408(d)(4) and recharacterized contributions under section 408A(d)(6), 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 the final regulations, generally, the 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 made to the IRA during the computation period. A special rule is provided for an IRA asset that is not normally valued on a daily basis. In this case, 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. One commentator suggested that the application of this special rule be extended to all IRA assets as an alternate fair market value determination so that the value of an IRA at the beginning of the computation period could be the most recent statement value just prior to the contribution, rather than the actual value on the exact date of the contribution.

The final regulations do not extend the special valuation rule to all IRA assets because the IRS and Treasury believe that if an IRA asset is normally valued on a daily basis, these values must be used so that the calculation of the amount of net income attributable to

a contribution is based on the actual earnings and losses of the IRA during the time it held the contribution. The alternate rule suggested by the commentator would increase the chances of producing anomalous results because account activity in the part of the year that precedes the date the contribution was made would be taken into account in the calculation of the net income attributable to the contribution.

One commentator suggested that where both regular Roth IRA contributions and conversion contributions have been made to the same Roth IRA, the net income calculation attributable to a recharacterization of a conversion contribution may require that some of the regular Roth IRA contributions be recharacterized to the traditional IRA. The commentator recommended that if a conversion contribution is being recharacterized, and the Roth IRA contains both regular contributions and conversion contributions, the final rules should permit the principal amount of any regular Roth IRA contributions in that same Roth IRA to remain in the Roth IRA.

The final regulations retain the rule, without modification, that 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 do not permit net income, including any losses, to be allocated other than *pro rata*. Thus, the principal amount of regular Roth IRA contributions cannot be protected against adjustment for their *pro rata* share of net income, including any net losses, during the computation period. Once contributions are commingled in an account, those dollars are no longer associated with particular assets or contributions. 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.

## Effective Date

These final regulations are 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 the proposed regulations.