Part III -- Administrative, Procedural, and Miscellaneous
Earnings Calculation for Returned or Recharacterized IRA Contributions

Notice 2000-39

I. PURPOSE

This notice permits a new method to be used for calculating the net income attributable to IRA contributions made after 1999 that are distributed as a returned contribution pursuant to § 408(d)(4) of the Internal Revenue Code ("Code") or recharacterized pursuant to § 408A(d)(6). However, until further guidance is issued, net income may continue to be calculated under the existing method set forth in the Income Tax Regulations.

II. BACKGROUND

A. Returned Contributions under § 408(d)(4)

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 1.408-4(c)(2)(ii) of the Income Tax Regulations prescribes the method for calculating the amount of net income attributable to a contribution distributed pursuant to § 408(d)(4). That method, referred to in this notice as 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 a negative amount.

B. Recharacterizations under § 408A(d)(6)

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 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 1.408A-5, Q&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 a negative amount. Section 1.408A, Q&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.

C. Requests for Alternative Method

The Internal Revenue Service has received comments that the old method for calculating net income attributable to an IRA contribution often does not reflect the actual earnings and losses of the IRA during the time it held the contribution. 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 addition, IRA owners and other interested parties have indicated that net income should be permitted to be a negative amount.

In response to these comments, the Service and Treasury are providing 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. Until further guidance is issued, net income may be calculated under either the new method or the old method. However, it is intended that future guidance will provide that the new method is the only method for calculating net income, and comments are requested regarding the new method and the effective date of mandatory use of the new method.

III. NEW METHOD FOR NET INCOME CALCULATION UNDER § 408(d)(4)

Under the new method, for purposes of returned contributions under § 408(d)(4), the net income attributable to a contribution made to an IRA after December 31, 1999, is determined by allocating to the contribution a pro-rata portion of the earnings accrued by the IRA during the period the IRA held the contribution. The new method is represented by the following formula:

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

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 made to the

IRA during the computation period (including the contribution that is distributed as a returned contribution pursuant to § 408(d)(4)).

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 made from the IRA during the computation period.

The "computation period" is the period beginning immediately prior to the time the particular contribution is made to the IRA and ending immediately prior to the removal of the contribution being returned.

For purposes of the above calculation, 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 determining net income, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

Under the new method set forth above, net income may be a negative number.

In the case of multiple regular contributions to an IRA, the last regular contribution made to the IRA for a particular taxable year is deemed to be the contribution that is distributed as a returned contribution under § 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution. For purposes of this notice, a "regular contribution" is 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.

In the case of an individual who owns multiple IRAs, the net income calculation is performed only on the IRA designated by the owner as containing the contribution that is to be distributed as a returned contribution, and that IRA is the IRA that must distribute the contribution.

Under the new method described above, if an IRA is established with a contribution and no other contributions or distributions are made to or from that IRA, then the subsequent distribution of the entire account balance of the IRA pursuant to § 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.

The following examples illustrate the new method net income calculation under § 408(d)(4):

Example 1. (i) On May 1, 2000, 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, 2000, contribution be returned to her pursuant to § 408(d)(4). Pursuant to this request, on February 1, 2001, 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, 2000, contribution is $75 [$400 x ($7,600 - $6,400) ÷ $6,400]. Therefore, the total to be distributed on February 1, 2001, pursuant to § 408(d)(4) is $475.

Example 2. (i) Beginning in 2000, Taxpayer B contributes $200 on the 15th of each month by payroll deduction to an IRA for 2000, resulting in an excess regular contribution of $400 for the year. Taxpayer B requests that the $400 excess regular contribution be returned to her pursuant to § 408(d)(4). Pursuant to this request, on March 1, 2001, when the IRA is worth $16,000, the IRA trustee distributes to Taxpayer B the $400 plus attributable net income. The excess regular contributions to be returned are deemed to be the last two made in 2000: the $200 December 15 contribution, when the IRA was worth $12,000 immediately prior to the contribution; and the $200 November 15 contribution, when the IRA was worth $11,000 immediately prior to the contribution. No distributions have been made from the IRA and no contributions, other than the payroll deduction contributions (including $200 in January and February 2001), have been made.

(ii) For the December 15 contribution, the adjusted opening balance is $12,600 [$12,000 + $200 + $200 + $200] and the adjusted closing balance is $16,000. Thus, the net income attributable to the December 15 contribution is $54 [$200 x ($16,000 - $12,600) ÷ $12,600]. For the November 15 contribution, the adjusted opening balance is $11,800 [$11,000 + $200 + $200 + $200 + $200] and the adjusted closing balance is $16,000. Thus, the net income attributable to the November 15 contribution is $71 [$200 x ($16,000 - $11,800) ÷ $11,800]. Therefore, the total to be distributed as returned contributions on March 1, 2001, to correct the excess regular contribution is $525 [$200 + $200 + $54 + $71].

IV. NEW METHOD FOR NET INCOME CALCULATION UNDER § 408A(d)(6)

Under the new method, for purposes of recharacterizations under § 408A(d)(6), the net income allocable to a contribution made to an IRA after December 31, 1999, is determined by allocating to the contribution a pro-rata portion of the earnings accrued by the IRA during the period the IRA held the contribution. The new method is represented by the following formula:

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

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 made to the IRA during the computation period (including the contribution that is recharacterized pursuant to § 408A(d)(6)).

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 made from the IRA during the computation period.

The "computation period" is 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.

For purposes of the above calculation, 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 determining net income, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

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

As under the old method, net income may be a negative amount. Also, as under the old method, 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 dollar amount, not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized.

Also as under the old method, if an IRA is established with a contribution and no other contributions or distributions are made to or from that IRA, then the subsequent recharacterization transfer of the entire account balance of the IRA pursuant to § 408A(d)(6) will satisfy the requirement of that Code section that the transfer be accompanied by any net income allocable to the contribution.

The following examples illustrate the new method net income calculation under § 408A(d)(6):

<u>Example 3.</u> (i) On March 1, 2000, when her Roth IRA is worth $80,000, Taxpayer C makes a $160,000 conversion contribution to the Roth IRA. Subsequently, Taxpayer C discovers that she was ineligible to make a Roth conversion contribution in 2000 and so she requests that the $160,000 be recharacterized to a traditional IRA pursuant to § 408A(d)(6). Pursuant to this request, on March 1, 2001, 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 x ($225,000 - $240,000) ÷ $240,000]. Therefore, in order to recharacterize the March 1, 2000, $160,000 conversion contribution on March 1, 2001, the Roth IRA trustee must transfer from Taxpayer C's Roth IRA to her traditional IRA $150,000 [$160,000 - $10,000].

<u>Example 4.</u> (i) On April 1, 2000, when her traditional IRA is worth $100,000, Taxpayer D 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 D decides that she would like to recharacterize the ABC Corp. shares back to a traditional IRA. However, D may choose only by dollar amount the contribution or portion thereof that is to be recharacterized. On the date of transfer, November 1, 2000, 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 D 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 x ($110,000 - $100,000) ÷ $100,000]. Therefore, in order to recharacterize $50,000 of the April 1, 2000, conversion contribution on November 1, 2000, the Roth IRA trustee must transfer from Taxpayer D's Roth IRA to a traditional IRA assets with a value of $55,000 [$50,000 + $5,000].

(iii) If, on the other hand, D 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 x ($110,000 - $100,000) ÷

$100,000]. Therefore, in order to recharacterize $40,000 of the April 1, 2000, conversion contribution on November 1, 2000, the Roth IRA trustee must transfer from Taxpayer D'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.

V. REQUEST FOR COMMENTS

The Service and Treasury invite comments and suggestions concerning the new method described in this notice for calculating net income under §§ 408(d)(4) and 408A(d)(6) and also concerning the effective date for a rule that would establish the new method as the only method for calculating net income under §§ 408(d)(4) and 408A(d)(6). Any correspondence received will be evaluated, together with appropriate considerations relating to tax administration, to determine the scope of future guidance.

Comments can be submitted to CC:DOM:CORP:R (Notice 2000-39), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 2000-39), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Roger Kuehnle of Employee Plans (Tax Exempt and Government Entities Division). For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday.