Pro-Rata Rule for after-tax money in an IRA

WELLS FARGO ADVISORS

It is important to understand the Pro-Rata Rule before you take a distribution when you have before-tax and after-tax amounts in any Traditional, SEP, and/or SIMPLE IRA. (These three will collectively be referred to as Traditional IRA(s) in the rest of this piece.) Amounts in a Roth IRA are not subject to this rule. After-tax amounts you may have in Inherited IRAs, where you are the beneficiary, will also use the pro-rata rule but are not included in the pro-rata calculation for your own Traditional IRAs.

The Internal Revenue Code's (IRC) pro-rata rule prevents you from being able to simply distribute or convert only the after-tax amount (basis) or before-tax amount. Instead, the pro-rata calculation is used to determine how much of a distribution or conversion is taxable when you have both after-tax and before-tax dollars in any of your Traditional IRAs.

Cream-in-your-coffee

The pro-rata rule is often referred to as the cream-in-your-coffee rule. Once the cream and coffee are combined, you cannot separate them; in the same way, blending before-tax and after-tax funds in any Traditional IRA(s) cannot be separated. This is true even if you keep the before-tax amounts in a different Traditional IRA from the after-tax amounts, as the year-end values of all Traditional IRA(s) are combined for purposes of determining the percentage of any distribution or conversion that is taxable.

Rolling after-tax QRP assets to a Traditional IRA

You may have made both before-tax and after-tax contributions to your qualified employer sponsored retirement plan (QRP) such as a 401(k), 403(b) or governmental 457(b). These after-tax amounts aren't the same as amounts contributed to a designated Roth account in your QRP. When separating from service, the entire plan balance, including any after-tax funds, can be rolled over to a Traditional IRA. Under the pro-rata rule, once you roll over after-tax QRP assets to a Traditional IRA, you must keep a separate accounting for these amounts on IRS form 8606, which will represent basis in your Traditional IRA.

Non-deductible IRA contributions

The pro-rata rule also applies to any IRAs where over the years you have made both deductible and non-deductible Traditional IRA contributions or have repaid reservist distributions. The ongoing filing of IRS form 8606, to keep track of the basis, is used to report all non-deductible contributions.

Pro-rata calculation

In order to determine the percentage of each IRA distribution that is not taxable, first, total the after-tax dollars in all of your Traditional IRAs. After-tax dollars include non-deductible IRA contributions, repaid reservist distributions, or rollovers of after-tax dollars from a QRP (the amounts can be found on IRS form 8606). Then, divide this amount by the 12/31 balance of all your Traditional IRAs combined. Next, multiply that percentage by the amount of all Traditional IRA distributions. The calculated amount represents the tax-free portion, and the balance of the Traditional IRA distribution is taxable. Remember you must also include all distributions including conversions and any outstanding rollovers* in that balance.

Pro-rata formula

Total Basis
(All after-tax money includes assets rolled over from QRP + Nondeductible contributions + repaid reservist distributions)

Balance in ALL Traditional, SEP, and SIMPLE IRAs as of 12/31 of the distribution year + all distributions (including conversions) + outstanding rollovers*

= % x All IRA distributions (including conversions) = Tax-free amount

Note: Calculations done prior to the end of the distribution year may not reflect the actual tax-free portion. This is because the calculation is based on the 12/31 value of your IRAs.

Pro-rata example

In this example, you have $100,000 before-tax and $10,000 after-tax in your Traditional IRA. You are rolling over your 401(k) with a balance of $300,000, $40,000 of which is after-tax contributions, to your Traditional IRA.

Once the rollover is completed, your Traditional IRA balance is $410,000. Let's assume that you decide to take a distribution of $50,000 to pay for a year of fun and travel, thinking that this amount is your basis, or total after-tax contributions. Your Traditional IRA balance on 12/31 is $360,000.

*An outstanding rollover is any amount distributed by an IRA in one year that is not rolled over to another IRA until the following year, but within the requisite 60-day period from receipt of the distribution.

WHOOPS! The $50,000 cannot be distributed tax-free. The pro-rata rule allows only $6,000 of the distribution to be tax-free and you must pay tax on the other $44,000.

Pro-rata hypothetical example

$$\frac{\$50{,}000}{\$410{,}000}$$

($360,000 12/31 balance + $50,000 distribution)

= .12 X $50,000 = $6,000

Note: Calculations done prior to the end of the distribution year may not reflect the actual tax-free portion. This is because the calculation is based on the 12/31 value of your IRAs.

Pro-rata and Roth conversion

Remember, too, that once after-tax money from your QRP is rolled to a Traditional IRA, it is also eligible to be converted to a Roth IRA. The same pro-rata formula applies when calculating the taxes due on a Roth conversion. However, the pro-rata rule does not apply to Roth IRA distributions. Non-qualifed Roth IRA distributions are subject to a different set of rules called ordering rules.

Roth conversion hypothetical example

How would a Roth conversion work using the previous pro-rata example? In this hypothetical example, you decide to convert $50,000 to a Roth IRA, thinking you won't pay taxes because these are after-tax dollars. As previously shown with the pro-rata calculation, only $6,000 of the conversion isn't taxable. The remaining $44,000 will be taxed at your ordinary income bracket. Generally, tax on a Roth conversion is due in the year of conversion.

Convert QRP after-tax amounts

You do not have to roll your after-tax non-designated Roth QRP amounts to a Traditional IRA, instead you could chose to roll them to a Roth IRA as a conversion. A partial distribution must include a proportional share of the before and after-tax amounts in the account. It is important to know that you can allocate the before and after-tax eligible distributions to more than one destination, such as a new employer's QRP, a Traditional IRA, a Roth IRA and/or yourself. This allows you the option to elect a direct rollover of the before-tax amounts to a Traditional IRA without any tax liability and then roll the after-tax amounts to a Roth IRA as a tax-free conversion. Additionally, you could have the distribution made payable to you and within 60 days decide to convert some or the entire amount to your Roth IRA.
A conversion of after-tax amounts is not a taxable event. In addition, should you decide to convert those after tax amounts, remember those amounts are not subject to the IRS 10% additional tax for early, pre-59½, distributions when following the Roth distribution ordering rules. This strategy alleviates the blending of the before and after-tax amounts in your Traditional IRAs and negates the need for the pro-rata calculation.

Remember

Keep your IRS form 8606 with other essential papers as it is important for your beneficiaries to be aware that your Traditional IRAs have after-tax amounts. The pro-rata rule will apply to distributions taken by your beneficiary because your Traditional IRAs will still have after-tax amounts in them.

Talk to Wells Fargo Advisors

At Wells Fargo Advisors, we understand the importance of providing IRA education to our clients and prospects. Since this is a complex topic with potential tax ramifications, we suggest you work with your tax advisor about your specific situation. Your financial advisor with Wells Fargo Advisors will be happy to work with your tax professional.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your Financial Advisor will be with you every step of the way to monitor your progress and adapt your plan as needed. Working together, we'll design and implement a retirement plan that can help you live out your unique vision of retirement.