

Any Questions?

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Pro-rata rule for after-tax money in an IRA

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.

*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.

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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*

$$= \% \times \text{All IRA distributions (including conversions)} = \text{Tax free amount}$$

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.

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)

$$= .12 \times \$50,000 = \$6,000$$

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-qualified Roth IRA distributions are subject to a different set of rules called ordering rules.

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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 choose 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.



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