

Calculating the Pro-Rata Rule in 5 Easy Steps

What is the pro-rata rule? The pro-rata rule is the formula used to determine how much of a distribution is taxable when the account owner holds both after-tax and pre-tax dollars in their IRA(s). For the purposes of the pro-rata rule, the IRS looks at all your SEP, SIMPLE, and Traditional IRAs as if they were one. Even if you have been making after-tax contributions to a separate account for years, and there have been no earnings, you cannot isolate your after-tax amounts and must take your other IRAs into consideration.

- 1. Total up all of your IRAs.** Calculate the total balance of all of your IRAs. Include the balances from each of your IRA accounts, including SEP IRAs and SIMPLE IRAs. Roth IRA balances and balances from any non-IRA based company plans are NOT included for this purpose.
- 2. Total up all after-tax dollars in IRAs.** Calculate the total balance of all after-tax dollars in all of your IRAs. After-tax dollars are either non-deductible contributions made directly to an IRA or rollovers of after-tax dollars from a company plan. If this is not the first year you have had after-tax dollars in your IRA, you should be able to find the previous year's after-tax total on IRS Form 8606.
- 3. Calculate your percentage of after-tax dollars.** Divide your after-tax IRA dollars (step 2) by your total IRA balance (step 1). If you have \$20,000 of after-tax dollars in all your IRAs and the total balance of all your IRAs is \$100,000, your percentage of after-tax dollars is 20% ($\$20,000/\$100,000 = 20\%$).
- 4. Determine the taxable amount of your distribution.** Take the total of all your distributions and multiply it by the percentage you have arrived at in step #3. This is the total amount of the distribution that is tax free. If, in our example, a distribution of \$10,000 was made, the tax-free portion would be \$2,000 ($20\% \times \$10,000 = \$2,000$). The remaining portion of the distribution (\$8,000) would be taxable at ordinary rates.
- 5. Exception for rollovers to a company plan or charitable rollovers.** Under the Tax Code, only pre-tax dollars can be rolled from an IRA into a company plan. If you are making a rollover from your IRA to a company plan, disregard the pro-rata rule altogether. Just be careful not to roll over more than the total amount of pre-tax dollars in all your IRAs. Qualified charitable distributions (QCDs) from IRAs also disregard the pro-rata rule.