



# ED SLOTT'S IRA ADVISOR

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Tax & Estate Planning for Your Retirement Savings

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## Probing the Pro-Rata Rule

The tax code's "pro-rata rule" is often misunderstood and can have disastrous consequences for those oblivious to its impact. With more and more individuals completing Roth conversions (including Backdoor Roth conversions) to take advantage of current, low income tax rates, it is now more important than ever to understand exactly how the rule works.

### Background

The pro-rata rule is used to calculate how much of a traditional IRA distribution is taxable (i.e., how much of an individual's basis is returned) when an IRA account owner has both pre-tax and after-tax monies in her IRA. Only IRA owners who have after-tax funds in one of their IRAs will be affected by the pro-rata rule.

The pro-rata rule treats all of a person's IRAs as one big account. This includes SEP and SIMPLE IRAs (but not Roth IRAs or inherited IRAs). Even IRAs held at different financial institutions are aggregated.

Due to this mandatory aggregation, an individual who owns a mix of pre-tax and after-tax dollars in her IRA accounts cannot simply take a tax-free distribution of the after-tax dollars. Instead, each distribution is treated as consisting partly of pre-tax (taxable) IRA monies and partly of after-tax (nontaxable) IRA monies.

We like to call this the "cream-in-the-coffee rule." Once after-tax funds (the cream) have been combined with pre-tax funds (the coffee) in the aggregated IRA, every sip (distribution) taken from any IRA will include some cream and some coffee.

The pro-rata rule applies whenever someone with basis (after-tax dollars) in her IRA receives a traditional IRA distribution, including when an IRA is converted to a Roth IRA or when an RMD is taken. If the taxpayer has zero basis in any traditional IRA, SEP or SIMPLE, then the pro-rata rule has no application, and the entire IRA distribution is fully taxable.

### The Pro-Rata Formula

The pro-rata calculation is done at the end of each calendar year and covers all traditional IRA distributions made during that year. Since the IRS considers a Roth conversion as a distribution from a traditional IRA, the calculation also covers conversions.

**Step 1:** Total the balance of all IRAs (both pre- and after-tax) required to be aggregated and add to that the amount of all distributions taken during the year. The aggregated balance is determined as of 12/31 of the year of distribution — *not as of the date of distribution.* (Note: If the IRA owner rolls over a traditional IRA before year-end that is not completed until the following year, the "in transit"

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