



The Pro-Rata Rule:

Your Retirement Savings Aren't
Always as Sweet as Kool-Aid

As kids on a hot summer day, we all learned by heart the formula for Kool-Aid:

- Fill a pitcher with water.
- Mix one packet of Kool-Aid.
- Mix one cup of sugar.
- Stir. Pour over ice. Enjoy.

We also understood one undeniable fact: Once you poured in that packet, you couldn't unmix the Kool-Aid and turn it back into water.

Who knew your retirement savings are a lot like that glass of Kool-Aid? Well, the Internal Revenue Service for one. Imagine your Traditional IRA as that pitcher. You pour in pre-tax contributions (like the water), and you also contribute after-tax dollars (like the sugar). This creates a blended mixture – a combined account where the pre-tax and after-tax funds are inextricably intertwined.

(Some tax experts call this the “cream-in-your-coffee rule,” but Kool-Aid always feels sweeter to me.)

This “mixed blend” is where the **pro-rata rule** comes into play. It governs how withdrawals from this combined account are taxed. Since you can't easily separate the pre-tax and after-tax portions, the IRS doesn't let you either. Instead, it applies a pro-rata calculation to determine the taxable portion of each withdrawal.

THE PRO-RATA RULE: CONFUSING DILEMMA?

This rule is notorious for causing headaches among retirement savers. It is a formula that determines the taxable portion of your Traditional IRA distributions based on the proportion of after-tax contributions to the total account balance.

Essentially, the IRS assumes you withdraw funds proportionally from both the pre-tax and after-tax portions of your account, regardless of your actual withdrawal strategy. This “one-size-fits-all” approach can feel arbitrary and frustrating, especially when you have carefully tracked after-tax contributions.

A QUICK EXAMPLE

Let's take out a calculator and try some math on for size.

Imagine Sarah has a Traditional IRA with \$150,000 in pre-tax contributions and \$20,000 in after-tax contributions. She recently rolled over her 401(k) into her Traditional IRA. Her 401(k) had a balance of \$250,000, including \$30,000 in after-tax contributions.

After the rollover, Sarah's Traditional IRA balance is now \$420,000. She's considering withdrawing \$40,000 to put a down payment on a new home.

To determine how much of Sarah's withdrawal is taxable, we need to use the pro-rata rule.

Calculate Total After-Tax Basis:

- Sarah's original Traditional IRA after-tax contributions: \$20,000
- After-tax contributions from the 401(k) rollover: \$30,000
- Total After-Tax Basis: $\$20,000 + \$30,000 = \$50,000$
- Total IRA Balance: \$420,000
- Percentage of After-Tax Basis: $\$50,000 / \$420,000 = 0.119$ or 11.9%

Calculate Tax-Free Portion of the Withdrawal:

- Withdrawal Amount: \$40,000
- Percentage of After-Tax Basis: 11.9%
- Tax-Free Portion: $\$40,000 * 0.119 = \$4,760$

Calculate Taxable Portion of the Withdrawal:

- Withdrawal Amount: \$40,000
- Tax-Free Portion: \$4,760
- Taxable Portion: $\$40,000 - \$4,760 = \$35,240$

In this example, Sarah will need to pay taxes on \$35,240 of her \$40,000 withdrawal.

The pro-rata rule can significantly impact the tax implications of your Traditional IRA withdrawals. It's crucial to understand this rule and accurately track your after-tax contributions to minimize your tax liability.

RECORD KEEPING IS EVERYTHING

Accurate record-keeping is crucial for navigating the pro-rata rule. You must track all after-tax contributions to your Traditional IRAs using IRS Form 8606. This includes:

- **Non-deductible IRA contributions:** These are contributions made with after-tax dollars.
- **Repaid reservist distributions:** If you previously withdrew funds from your Traditional IRA while serving in the military and later repaid those withdrawals, these repayments are considered after-tax contributions.
- **Rollovers of after-tax QRP assets:** When you roll over your 401(k), 403(b), or other qualified retirement plan (QRP) to a Traditional IRA, any after-tax contributions in your QRP are also included in your after-tax basis.

THE BACKDOOR ROTH IRA AND THE PRO-RATA RULE

The pro-rata rule can significantly impact your ability to effectively utilize the backdoor Roth IRA strategy. This strategy involves contributing to a Traditional IRA and then immediately converting those contributions on an after-tax basis to a Roth IRA.

However, if you already have pre-tax funds in your Traditional IRA, the pro-rata rule will determine the taxable portion of your conversion. This can significantly reduce the tax benefits of the backdoor Roth IRA,

as only a small percentage of the conversion may be tax-free.

QUALIFIED PLANS: A DIFFERENT APPROACH

The pro-rata rule applies differently to qualified plans like 401(k)s. These plans typically allow you to designate whether your contributions are made on a pre-tax or after-tax basis. This makes it easier to track and withdraw funds accordingly.

But it is important to remember that after-tax contributions from a 401(k) plan can be rolled over to a Traditional IRA. And guess what? Even those after-tax dollars are eligible for a Roth IRA conversion. Just like with regular withdrawals, the pro-rata rule determines the taxable portion of this conversion.

But here's the good news: the pro-rata rule doesn't apply to withdrawals made from a Roth IRA.

NAVIGATING THE PRO-RATA RULE

The pro-rata rule can be complex, but understanding how it works is crucial for making informed decisions about your retirement savings. By carefully tracking your after-tax contributions and consulting with a qualified financial advisor, you can minimize the potential tax implications of the pro-rata rule and maximize the benefits of your retirement savings.

Good News? You aren't in this alone. Rules and regulations that can impact your tax and retirement planning strategies are why you chose to work with a financial advisor. We are always happy to sit down with you and your tax professional to examine the best course of action for your unique situation.



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