EXCEPTIONS TO THE PRO-RATA RULE – WAYS TO "ISOLATE BASIS"

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My November 29 Slott Report entry was titled "The Pro-Rata Rule Explained – You are Not Getting Taxed Twice." I closed that article by stating there are exceptions to the pro-rata rule and ways to clean up an IRA that contains a mix of pre-tax and after-tax dollars (basis). Included here are three exceptions to pro-rata and how IRA owners could potentially "isolate basis" – reduce an IRA to only after-tax dollars, thereby setting the stage for a tax-fee Roth conversion.

Qualified Health Savings Account Funding Distribution (QHFD). An IRA owner is allowed to make a one-time tax-free transfer from an IRA to a health savings account. This transfer is not subject to the 10% early withdrawal penalty and is a unique way to fund an HSA, if only for one time. The drawback is that the amount of the transfer is capped by the HSA contribution limits for that year, based on the IRA owner's coverage (i.e., self-only or family). Since a QHFD can only be done with pre-tax dollars, it is an exception to the pro-rata rule.

The amount of a QHFD is limited, so using this strategy to separate pre-tax dollars from after-tax within an IRA can only go so far. For an IRA owner trying to completely "isolate basis" in his IRA with a QHFD, he must have a relatively small taxable IRA balance. (The 2021 HSA family contribution limit for age 55 or older is $8,200.)

Qualified Charitable Distributions (QCDs). QCDs are available to IRA owners aged 70 ½ or older and capped at $100,000 per person, per year. A QCD only applies to direct transfers of IRA funds to charities. Gifts made to private grant making foundations, donor advised funds or charitable gift annuities do <u>not</u> qualify.

Like QHFDs, QCDs apply only to taxable amounts, which makes QCDs another exception to the pro-rata rule. By leveraging annual QCDs, an IRA owner could significantly reduce taxable dollars in his IRA, thereby further isolating basis.

Rollovers from IRAs to Company Plans. A third exception to the pro-rata rule and method to isolate basis is what some refer to as a "reverse rollover" – rolling IRA money to a company plan, like a 401(k). Only pre-tax funds can be rolled from an IRA to a company plan. As such, this is the most popular way to isolate basis. But it is not available to everyone. A person must have access to a work plan, and that plan must accept rollovers. Not all do. For those IRA owners fortunate enough to be able to complete a "reverse rollover," the entire IRA basis problem can be cleaned up in one fell swoop.

There are no limits to how much can be rolled over like there is with QHFDs and QCDs. An IRA owner looking to isolate basis could roll over his entire bucket of pre-tax IRA dollars into a work plan, leaving behind only the after-tax dollars. At that point he could process a tax-free Roth conversion of the after-tax dollars in his IRA. The former pre-tax IRA dollars in the plan could then be returned to the IRA the following year. (Warning: If you pursue this strategy, it is imperative that you NOT roll the pre-tax plan dollars back to the IRA until at least the next year, or they will be included in the previous Roth conversion pro-rata math.)

Of course, all this talk of converting after-tax dollars to a Roth IRA could be made null and void by the current tax proposals. Time will tell if such transactions are outlawed. As for those looking to clean up their IRAs by isolating basis in 2021, the window of opportunity is still open!