THE 3 EXCEPTIONS TO THE PRO-RATA RULE THAT YOU NEED TO KNOW

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Most IRA distributions will be taxable. However, if you have ever made nondeductible contributions to your IRA or rolled over after-tax funds from your company plan to your IRA, then the rules can get a little bit tricky. You will need to understand the pro-rata rule.

The pro-rate rule is a rule that almost always determines the taxation of an IRA distribution when the IRA owner has any IRA containing after-tax amounts. However, some IRA distributions are not subject to the pro-rata rule. These exceptions may provide an opportunity for you to lower the tax bill that comes with an IRA distribution or conversion.

The Pro-Rata Formula

You may have more than one IRA. For example, you may have an IRA that was rolled over from a former employer, a SIMPLE IRA with your current employer, an IRA where you make annual deductible contributions, and a IRA where a long time ago you made some contributions for which you did not take a deduction. Usually, when you take an IRA distribution, all of your IRAs (except Roth IRAs) are considered one big IRA.

With the pro-rata formula, you take the total year-end balance of all your IRAs and divide that into the total balance of all after-tax amounts in all your IRAs. The resulting percentage is then applied to the distribution to determine the tax-free portion of your distribution. The remaining part of the distribution is taxable. You cannot separate out any one part of your IRAs and select only that part to be your distribution. You cannot take out or convert only the after-tax funds in your IRAs. You must use the pro-rate formula. The pro rata formula is determined using IRS Form 8606.

Exceptions to the Pro-Rata Rule

While most IRA distributions are subject to the pro-rata rule, you should know that there are some exceptions. Three distributions that are not subject to the pro-rata rule include:

1. Rollovers to Company Plans – You may rollover your taxable IRA funds to your company plan if the plan allows.

2. Qualified Charitable Distributions (QCDs) - Each year if you are age 70 ½ or older, you can transfer up to $100,000 from your IRA to a charity tax-free.

3. Qualified HSA Funding Distributions (QHFDs) – You are permitted to do a QHFD once in your lifetime. This is a tax-free transfer from your IRA to you HSA. The amount that can be transferred cannot exceed the amount you are eligible to contribute to your HSA for the year.

You can only fund each of these distribution with the taxable part of your IRA. The pro-rata rule will not apply. Instead, the distribution will consist only of taxable IRA funds.

Strategy to Reduce Taxes

If you are eligible, using one of these three exceptions is strategy that can pay off when it comes how your IRA distributions are taxed. Each strategy allows you to move only your taxable IRA funds out of your IRA. This means that a greater percentage of what is left behind will be after-tax funds. When you convert or take a distribution, this means that less will be taxable. A smaller tax bill is good news for you. Want to learn more and find out if this is a good strategy for you? A good move is to discuss your situation with a tax or financial advisor who is knowledgeable about the IRA rules.