

FORM 8606 AND THE PRO-RATA RULE: NOT THE END OF THE WORLD

June 17, 2026

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If a person has after-tax (non-deductible) money in any traditional IRA, SEP or SIMPLE IRA, then the pro-rata rule is just something that needs to be dealt with. But pro-rata is not the end-of-days hurdle that many people perceive it to be. In fact, with current tax software doing most of the heavy lifting, pro-rata might be considered a non-issue.

When after-tax (non-Roth) money exists in an IRA, the IRA owner cannot cherry-pick only those dollars for withdrawal or conversion to a Roth IRA. Barring a few exceptions, a proportionate amount of pre-tax (taxable) dollars and after-tax (non-taxable) dollars are required to be included in any withdrawal. That is the pro-rata rule in a nutshell.

How does an IRA owner document the after-tax dollars in his IRA and the amount of any withdrawal (or conversion) that is taxable? On IRS Form 8606. When a person makes a non-deductible contribution to a traditional IRA, Form 8606 is required to “claim the basis.” Form 8606 is essentially the IRA owner waving a flag to the IRS and saying, “I am putting after-tax dollars into my IRA.” Often, people intentionally make a non-deductible contribution to initiate a Backdoor Roth IRA transaction. But sometimes non-deductible contributions happen by mistake. Someone will contribute to a traditional IRA, realize later that it is not eligible for a deduction, and then just leave the contribution as-is.

Where people often get sideways with the pro-rata rule is thinking it applies to each IRA individually. Such is not the case. The pro-rata rule considers all of a person’s traditional IRAs, SEP and SIMPLE IRAs as one big bucket of money. If a person with pre-tax (non-Roth) dollars in one IRA makes a non-deductible contribution to another IRA (and the only dollars in that IRA are those after-tax dollars), a subsequent full Roth conversion of just that second IRA does NOT mean that only the after-tax dollars can be converted. As mentioned, the IRS considers all of a person’s IRAs for the pro-rata rule. No cherry picking.

Misunderstandings of the pro-rata rule like this, especially when it comes to the Backdoor Roth strategy, happen all the time. And when the IRA owner realizes that Form 8606 is now involved, along with a potential lifetime of pro-rata math, panic often ensues. How do I unwind this? How can I avoid pro-rata? How can I make this all go away?

To this, we say, “Just breathe. It is not the end of the world.”

Form 8606 is only needed in the year of a non-deductible contribution and in any year when a subsequent withdrawal or conversion is done. So, after a non-deductible IRA contribution is made, if the IRA owner makes no further such contributions, takes no distributions or does no Roth conversions for the next decade, then no Form 8606 is required for those years. Once the original basis is claimed on the form, it is locked in. And if the information on Form 8606 is properly entered into tax prep software, the software should carry that information forward for years to come. When a future distribution is taken or a Roth conversion is done, the tax software will simply compute the pro-rata math for you. Easy peasy.

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