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IRA Distributions: Accounting for the Pro-Rata Rule

By Ed Slott, CPA

Withdrawals from a traditional IRA are taxed as ordinary income in the year of the distribution if all IRA contributions were made with pre-tax funds. But calculating the taxable amount may not be that simple if you made after-tax contributions, especially if you have multiple IRAs. In that case, the pro-rata rule is used to determine the percentage of each distribution that is taxable.

Furthermore, the U.S. tax code treats all your pre-tax IRA assets as one combined account, so you can't simply take a tax-free distribution of the after-tax dollars. This aggregation requirement applies to assets in all traditional, SEP, and SIMPLE IRAs, even if the accounts are held at different financial institutions. (Roth and inherited IRA assets are excluded.)

The pro-rata rule is sometimes called the "cream in the coffee rule" because once after-tax dollars ("the cream") combine with pre-tax dollars ("the coffee"), distributions from any of your non-Roth IRA accounts will have an inseparable mix of both. Thus, you should consider the potential impact of the pro-rata rule well before you intend to retire or begin taking any taxable IRA distributions — including Roth conversions — as there may be worthwhile opportunities to help blunt its impact.

> You may be able to lessen the impact of the pro-rata rule by reducing the amount of pre-tax IRA dollars by year-end.

Doing the Math

Here are the steps involved in calculating the taxable portion of a distribution from a pre-tax IRA account.

Step 1: Total the balance of all IRAs (both pre-tax and after-tax) required to be aggregated as of December 31 of the year the distribution was taken.

Step 2: Add the amount of all distributions (and conversions) taken during the same calendar year.

Step 3: Total the after-tax dollars (or basis) in all SEP, SIMPLE, and traditional IRAs. The basis includes nondeductible IRA contributions and/or after-tax 401(k) contributions rolled over to an IRA.

Step 4: Determine the *pro-rata percentage* of after-tax dollars by dividing the Step 3 amount by the Step 2 amount.

Step 5: Calculate the nontaxable portion of your calendar-year distributions by multiplying the Step 4 percentage by the amount of the distribution. The remainder of the distribution is taxable income.

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If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.

Should You Speed Up Your Retirement Plans?

According to a March 2021 survey, an estimated 2.8 million Americans ages 55 and older decided to file for Social Security benefits earlier than they expected because of COVID-19. This was about double the 1.4 million people in the same age group who said they expected to work longer, presumably due to pandemic-related financial losses.[1]

Many older workers were pushed into retirement after losing their jobs, and others may have had health concerns. Still, it appears that work-related stress and the emotional toll of the pandemic caused a lot of people to rethink their priorities and their retirement timelines.

How do you know if you can realistically afford to retire early? First and foremost, determine whether you will have enough income to support the lifestyle you envision. Instead of accumulating assets, you may have to start draining your life savings to cover living expenses. Here are four important factors to consider.

Lost Income and Savings

You may be sacrificing years of future earnings and contributions to your retirement accounts. For example, an early retiree who was making $80,000 per year would forgo about $400,000 of salary over five years or $800,000 over a decade, not counting cost-of-living or merit increases. The 10-year total rises to nearly $1 million when annual raises averaging just 3% are included.

Source: Pew Research Center, 2020

If the same retiree could have contributed 5% of salary to an employer-sponsored retirement plan with a 100% match, he or she would also miss out on $8,000 in contributions in the first year, more than $40,000 over five years, and almost $100,000 over 10 years.

Debt and Other Financial Responsibilities

If you are still paying a mortgage, have other debts, or are supporting children or aging parents, you may not be ready to retire. Ideally, you should be free of "extra" financial responsibilities so you can focus on meeting your own living expenses without a regular paycheck.

Reduced Social Security Benefits

The earliest age you can file for Social Security is 62, but your benefit would be reduced to 70% or 75% of your full retirement benefit — for the rest of your life. So even if you do decide to retire, you might think about waiting to claim your benefit until you reach full retirement age (66 or 67, depending on the year you were born) or longer if you have enough income and/or savings to cover your expenses. For every year you wait past your full retirement age, your benefits will increase by 8% (up to age 70).

Higher Medical Costs

If you retire before you (or a spouse) become eligible for Medicare at age 65, you could lose access to an affordable employer-provided health plan. You can purchase health insurance through the Health Insurance Marketplace or a broker, but the age-based premiums are more expensive for older applicants. For two 60-year-olds with a household income of $100,000, the average premium for a silver Marketplace plan in 2021 is $708 per month ($8,500 per year), after subsidies. And if you seek medical treatment, you'll typically need to cover copays, deductibles, coinsurance, and some other expenses (up to the plan's out-of-pocket maximum).[2]

Even with Medicare, it's estimated that a married couple who retired at age 65 in 2020, with median expenses for prescription drugs, would need $270,000 to have a 90% chance of paying their health-care costs throughout retirement.[3]

The bottom line is that some people might be giving up more than they realize when they retire early. Before you say goodbye to the working world, be sure you have the resources to carry you through the next phase of your life.

1) U.S. Census Bureau, 2021
2) Kaiser Family Foundation, 2021
3) Employee Benefit Research Institute, 2020

Company Stock and Your Retirement Strategy

The opportunity to acquire company stock — inside or outside a workplace retirement plan — can be a lucrative employee benefit. Your compensation may include stock options or bonuses paid in company stock. Shares may be offered at a discount through an employee stock purchase plan and held in a taxable account, or company stock might be one of the investment options in your tax-deferred 401(k) plan.

Either way, having too much of your retirement savings or net worth invested in your employer's stock could become a problem if the company or sector hits hard times. There are also some tax implications to consider.

Concentrate on Diversification

The possibility of heavy losses from having a large portion of your portfolio holdings in one investment, asset class, or market segment is known as *concentration risk*. Buying shares of any individual stock carries risks specific to that company or industry, so a shift in market forces, regulation, technology, competition, scandals, and other unexpected events could damage the value of the business.

Holding more than 10% to 15% of your assets in company stock could upend your retirement strategy if the stock suddenly declines in value, and overconcentration can sneak up on you as your position builds slowly over time. To help maintain a healthy level of diversification in your portfolio, look closely at your plan's investment options and consider directing some of your contributions into funds that provide exposure to a wider variety of market sectors.

You might also consider strategies that involve selling company shares systematically or right after they become vested. But make sure you are aware of the rules, restrictions, and time frames for liquidating company stock, as well as any possible tax consequences.

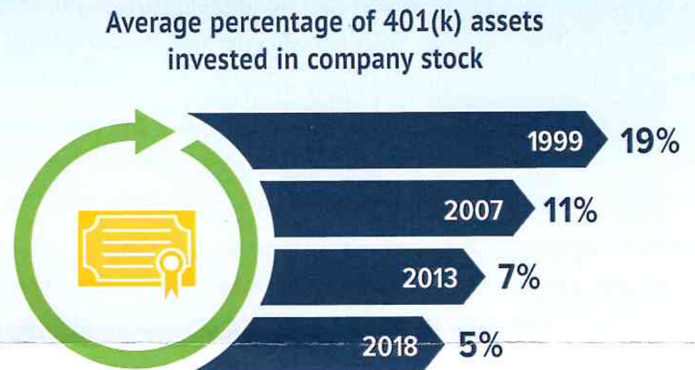
Take Advantage of NUA

If you sell stock inside your 401(k) account and reinvest in other plan options, or you roll the stock over to an IRA, future distributions will likely be taxed as ordinary income. However, if you own highly appreciated company stock in your employer plan, you might benefit from a special tax break on lump-sum distributions of net unrealized appreciation (NUA). NUA allows the appreciation on company stock in a 401(k) to be taxed at lower long-term capital gains rates when the shares are sold, instead of the ordinary income tax rates that would otherwise apply to retirement plan distributions.

Company Stock Allocations

Ownership of company stock in 401(k) plans has fallen considerably since 1999.

Average percentage of 401(k) assets invested in company stock



Source: Employee Benefit Research Institute, 2021 [data from participants in the 2018 EBRI/ICI 401(k) database]

To qualify for NUA, the lump-sum distribution must follow a triggering event such as separation from service, reaching age 59½, disability, or death. The stock must be distributed in kind — as stock — and transferred to a taxable account. You would owe income tax at the ordinary rate in the year of the distribution, but only on the cost basis of the stock.

If your retirement plan consists of employer stock and other types of investments (cash, mutual funds, etc.), the other assets can be transferred to an IRA, to another employer's plan, or withdrawn entirely. This doesn't have to happen simultaneously with the stock distribution, but the distributions must occur in the same tax year, and the account balance on your employer plan must be zero by the end of that year.

If distributions of company stock are handled correctly, the savings from NUA can be substantial, especially for those in higher tax brackets. But keep in mind that taking any partial distribution from your employer plan after a triggering event — even an in-plan Roth conversion or required minimum distribution — could disqualify you from the NUA tax break, unless another triggering event occurs.

All investments are subject to market fluctuation, risk, and loss of principal. When sold, investments may be worth more or less than their original cost. Diversification and asset allocation are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.

A Map for Your Family

A will is an essential legal document that describes how your estate should be distributed upon your death. It is the basis for the probate process and can serve as a guide for your heirs.

A letter of instruction — which has no legal status — provides information that can help your loved ones settle your estate and move forward with their lives. You might consider it a map for your family.

Unlike a will, which must follow legal guidelines for your state and may require an attorney, a letter of instruction can be written yourself in any way you choose. Here are some topics you may want to address.

Financial accounts and account numbers, including online user names and passwords. If you prefer not to write down user names or passwords, the executor of your estate should be able to access accounts with the account numbers and your Social Security number.

List of documents and their locations, including (but not limited to) your will, insurance policies, tax returns, bank and investment account documents, real estate deeds and mortgage documents, vehicle titles, Social Security and Medicare cards, marriage and/or divorce papers, and birth certificate.

Contact information for professionals who handle your financial and legal affairs, such as your attorney, financial advisor, insurance agent, and accountant. Also include others who may be helpful, such as a business partner or trusted friend.

Bills and creditors, including when payments are due and other pertinent information, such as loan terms and balances as of the date of the letter.

Your final wishes for burial or cremation, a funeral or memorial service, organ donation, and charitable contributions in your memory.

You might also include more personal thoughts or life lessons that you want to pass on, or you could write a separate letter. Keep your letter of instruction in a safe, yet accessible place and tell your loved ones where it can be found. It might be wise to give a copy of the letter to the executor of your estate and other trusted friends or advisers.

Be sure to review the letter regularly and update it as appropriate. Your heirs will thank you for taking the time to prepare.

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Let's say that Peggy, who recently retired, takes distributions totaling $25,000 from her traditional IRA. That account has a balance of $300,000 at the end of the same year, and her after-tax basis in the IRA is $100,000. She also owns a SEP IRA, which has a balance of $200,000 and no after-tax funds, so the basis in that account is zero, and her combined IRA balance is $500,000. Calculating Peggy's pro-rata percentage of after-tax dollars ($100,000 ÷ $500,000 + $25,000 = .19) determines that 19% of her distribution will be tax-free. Therefore, the nontaxable portion of her calendar-year distributions ($25,000 x .19) is $4,750, and the amount of taxable income is $20,250.
This hypothetical example of mathematical principles is used for illustrative purposes only.

Isolating the Basis

You may be able to lessen the impact of the pro-rata rule by reducing the amount of pre-tax IRA dollars by year-end. This is called *isolating the basis*. If you have access to a workplace plan such as a 401(k) and reverse rollovers are permitted, you might consider rolling pre-tax IRA funds into the plan. You could also use pre-tax dollars to make a qualified charitable distribution or a qualified health savings account (HSA) funding distribution, which is a one-time direct transfer from an IRA to an HSA.

The IRA custodian will not calculate the taxable and nontaxable portions of any distribution. It is up to you to track your IRA basis by filing IRS Form 8606, which incorporates the pro-rata formula and determines any basis remaining at the end of the year.

Ed Slott is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.

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