

Nondeductible IRA contributions require careful tracking

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If, like many people, your traditional IRA holds a mixture of deductible (after-tax) and nondeductible (pretax) contributions, it's important to track your contributions carefully to avoid double taxation of distributions. Why? Because the IRS treats distributions as a blend of pretax and after-tax dollars. If you treat distributions as fully taxable, you'll end up overpaying.

An example

Dan, age 62, withdraws \$40,000 from his traditional IRA on August 1, 2019. At the time, his IRA balance is \$200,000, consisting of \$50,000 in deductible contributions, \$80,000 in nondeductible contributions and \$70,000 in investment earnings. On December 31, 2019, the IRA's balance is \$170,000 — \$200,000 minus the \$40,000 distribution plus additional contributions and earnings after August 1.

To ensure that his distribution is taxed correctly, Dan must calculate the portion attributable to nondeductible contributions. These are the contributions that were made with after-tax dollars and, therefore, aren't taxable again. First, he takes the IRA's year-end balance, \$170,000, and adds back the \$40,000 distribution, to arrive at \$210,000. Next, he divides his nondeductible contributions (\$80,000) by \$210,000 and multiplies the resulting percentage (38%) by the amount of the distribution. The result — \$15,200 — is the nondeductible portion of his distribution, which is tax-free. For purposes of future distributions, Dan's nondeductible contributions are reduced by \$15,200 to \$64,800.

Multiple IRAs

Be aware that, if you have several IRAs, including one or more that are funded exclusively with nondeductible contributions, you can't avoid tax by taking distributions from those accounts. All your traditional IRAs are treated as a single IRA for tax purposes, so your distributions are deemed to be a combination of taxable and nontaxable funds, regardless of the account they're withdrawn from.

The easiest way to track and report your deductible and nondeductible IRA contributions is to complete and file Form 8606, "Nondeductible IRAs," with your federal income tax return each year.

Please contact us with any questions you may have regarding your IRAs.

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