Abstract: Taxpayers who make nondeductible contributions to a traditional IRA need to understand the tax treatment of distributions to ensure they're not taxed twice on the same income. This article explains the risk and how to mitigate it.

Don't get taxed twice on nondeductible IRA contributions

Do you make nondeductible contributions to a traditional IRA? If so, you need to understand the tax treatment of distributions to ensure you're not taxed twice on the same income.

Justify your strategy

There are several reasons why you might contribute nondeductible amounts to an IRA:

1. You or your spouse has a retirement plan at work and your income exceeds the threshold, reducing or eliminating your IRA deductions.
2. Your income is too high to qualify for a Roth IRA contribution.
3. You still wish to make the maximum contribution (currently, $5,500 per year; $6,500 if you're 50 or older) to take advantage of tax-free growth.

But for this strategy to make sense, you need to ensure that you're not paying tax on IRA distributions of nondeductible (and, therefore, previously taxed) contributions. This will require you to calculate the portion of each distribution attributable to deductible and nondeductible contributions and file Form 8606 with your federal income tax return.

Do the math

To illustrate the procedure: Nick has $500,000 in his traditional IRA as of November 1, 2018. Of that balance, $125,000 is attributable to deductible contributions, $200,000 to nondeductible contributions and $175,000 to investment earnings within the IRA. Nick takes a $50,000 distribution from the IRA and reports the entire amount as taxable income on his 2018 return. By doing so, he pays tax a second time on the portion of the distribution attributable to nondeductible contributions, which were already taxed in the years he made those contributions.

To avoid double taxation, Nick must determine the portion of his distribution that's attributable to nondeductible contributions. Suppose the IRA's balance is $475,000 on December 31, 2018 — $500,000 less the $50,000 distribution plus additional earnings after November 1. To determine the nontaxable portion of the distribution, Nick adds the $50,000 distribution to his IRA's year-end balance (for a total of $525,000) and divides nondeductible contributions ($200,000) by that amount. He multiplies the resulting percentage — 38% — by the $50,000 distribution to determine the nontaxable portion ($19,000). Because $19,000 of Nick's distribution has come from nondeductible contributions, those are reduced by $19,000 (to $181,000) for purposes of future distributions.

Handle with care

A word of caution: You can't avoid taxes altogether by making nondeductible contributions to a separate account and then taking distributions from that account. For tax purposes, the IRS treats

all traditional IRAs as a single IRA. So your distributions will consist of a combination of taxable and nontaxable funds, regardless of which account they come from.

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