



AMERICA'S IRA EXPERTS

HOW THE ROTH IRA 5-YEAR RULE WORKS

Wednesday, August 23, 2023

By Sarah Brenner, JD
Director of Retirement Education

We are often asked how the Roth IRA 5-year rule works. This is a borderline trick question because there is not one 5-year rule for Roth IRA distributions. There are actually two different 5-year rules. So, to avoid confusion, let's talk separately about each 5-year rule.

5-Year Forever Rule

The first 5-year rule you need to understand is the rule that must be satisfied for qualified distributions from the Roth IRA. If a distribution from a Roth IRA is qualified, the entire distribution (including earnings) is tax free. To be "qualified," the distribution must be paid to the owner after age 59 ½ or be for disability or for the purchase of a first home, or to a beneficiary after the death of the Roth IRA owner.

In addition, a 5-year waiting period must also be satisfied. This 5-year period applies across the board to all of an individual's Roth IRAs. It starts with an individual's first contribution or conversion that is deposited to any Roth IRA. It does not restart with future contributions or conversions. We can call this rule the "5-Year Forever Rule" because it never restarts.

Once a person makes his first Roth IRA contribution or Roth conversion, his starting date for the "5-Year Forever Rule" is locked in. This is true even if all the Roth IRA funds are distributed at some point. The 5-year holding period begins on January 1

of the year for the first contribution or conversion to any Roth IRA. So, it may actually be less than a full five years.

5-Year 10% Penalty Rule

If there was only one 5-year rule to worry about for Roth IRA distributions, things would be a lot less complicated. However, that is not the case. There is a second 5-year rule that you need to understand. This one applies to distributions of converted funds to Roth IRA owners who are under age 59½. This 5-year holding period (that we will call the “5-Year 10% Penalty Rule”) is different than the 5-Year Forever Rule. Unlike the 5-Year Forever Rule, a fresh 5-Year 10% Penalty Rule is applied to each new conversion.

The best way to understand the 5-Year 10% Penalty Rule is to know its history and what it is designed to prevent. When Roth IRAs first became available, this rule did not exist. Many thought it would be possible for those under age 59 ½ to convert funds to a Roth IRA and then take an immediate distribution from the Roth IRA to avoid the 10% penalty. Congress said “not so fast” and imposed the “5-Year 10% Penalty Rule.”

If an individual, who is under age 59½, takes a distribution of converted funds before the end of the 5-year holding period, then a 10% early distribution penalty will apply to the distribution of any converted funds that were taxable at the time of the conversion. The converted funds will leave the Roth IRA beginning with the first dollars converted. In addition, the usual list of exceptions to the 10% penalty apply.

Copyright © 2023, Ed Slott and Company, LLC Reprinted from The Slott Report, August 23, 2023, with permission. <https://www.ira-help.com/slottreport/inherited-ira-rmd-requirements-and-roth-401k-rules-today%E2%80%99s-slott-report-mailbag>
Ed Slott and Company, LLC takes no responsibility for the current accuracy of this article.