Two Roth IRA 5-year rules: What you need to know

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The tax-deferred tax-free nature of the Roth individual retirement account (IRA) makes it a unique option for retirement savings. While there are annual contribution and income limits, Roth IRA conversions have no such restrictions. However, there are two separate and distinct 5-year rules that must be followed to make qualified withdrawals from a Roth IRA.

Rule 1: 5-year rule for penalty-free distributions from Roth IRA conversions

When Congress first passed the Roth IRA conversion legislation, this rule did not exist. An individual under age 59½ could convert funds from a traditional IRA to a Roth IRA and immediately take a distribution free of penalty and tax because of the Roth IRA distribution ordering rules. Roth IRA money comes out in this order: contributions, conversions and then earnings.

Congress then implemented the 5-year rule for penalty-free distributions from a Roth IRA conversion. If an individual under the age of 59½ executes a Roth IRA conversion and then takes a distribution within five years and before turning age 59½, the converted amount is subject to the 10% early withdrawal penalty. The five years begin January 1 of the year of the conversion.

One final aspect of this 5-year rule is that each conversion is independent of one another and has its own separate and distinct 5-year period.

This 5-year rule can only apply to individuals under 59½ years old.

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Rule 2: 5-year rule for qualified (tax-free) distributions

This rule is for income tax only and not the 10% penalty. Essentially, do the earnings come out tax-free? This 5-year clock starts the day the **first dollar** is contributed or converted to a Roth IRA.

Like conversions, contributions are deemed to be made on the first day of the calendar year in which the contribution happens. This clock **does not** re-start with subsequent contributions or conversions. To make a qualified distribution from a Roth IRA it must be held for at least five years **and** the individual is age 59½ or older or is due to death, disability or for a first-time home purchase ($10,000 maximum).

For example:

Jon, age 45, converts $100,000 to his first Roth IRA in June 2019.

His 5-year holding period begins on January 1, 2019, and ends on December 31, 2023. As of January 2024, the $100,000 has grown to $125,000.

- If Jon withdraws all $125,000, while he has held the Roth IRA for the 5-year period, he has not made a qualified withdrawal because he is under age 59½.
- The first $100,000 is not taxable because it is return of converted funds, which were already subject to tax.
- The $25,000 in earnings will be subject to both income tax and a 10% penalty because Jon is under age 59½.

If Jon was over age 59½, the withdrawal would be a qualified withdrawal and free of both penalty and income tax.

It's important to understand how both Roth IRA 5-year rules can impact qualified withdrawals. Examining why the rules are in place, and what they are trying to prevent, can help with understanding how they apply.