Two Five-Year Tests for Roth IRAs

The pros and cons of Roth IRAs, which were introduced 20 years ago, are well understood. All money flowing into Roth IRAs is after-tax, so there is no upfront tax benefit.

As a tradeoff, all qualified Roth IRA distributions can be tax-free, including the parts of the distributions that are payouts of investment earnings.

To be a qualified distribution, the distribution must meet two basic requirements. First, the distribution must be made on or after the date the account owner reaches age 59½, be made because the account owner is disabled, be made to a beneficiary or to the account owner's estate after his or her death, or be used to buy or rebuild a first home.

Second, the distribution must be made after the five-year period beginning with the first tax year for which a contribution was made to a Roth IRA set up for the owner's benefit.

Note that the calculation of a Roth IRA's five-year period is very generous. It always begins on January 1 of the calendar year.

Example 1: Heidi Walker, age 58, opens her first Roth IRA and makes a contribution to it on March 29, 2018. Heidi designates this as a contribution for 2017, which can be made until April 17, 2018.

Under the five-year rule, Heidi's five-year period starts on January 1, 2017. As of January 1, 2022, Heidi's Roth IRA distributions are tax-free, qualified distributions because they will have been made after she turned 59½ and after the five-year period has ended. The five-year period is determined based on the first contribution to the Roth IRA; the starting date of the five-year period is not reset for the subsequent contributions.

Note that if Heidi opens her first Roth IRA late in 2018, even in December, the first contribution will be a 2018 Roth IRA contribution and Heidi will reach the five-year mark on January 1, 2023.

Conversion Factors

Other than making regular contributions, Roth IRAs may be funded by converting a traditional IRA to a Roth IRA and paying tax on any pre-tax dollars moved to the Roth side. For such conversions, a separate five-year rule applies. There generally is a five-year waiting period before a Roth IRA owner who is under age 59½ can withdraw the dollars contributed to the Roth IRA in the conversion that were includible in income in the conversion, without owing a 10% early withdrawal penalty.

Similar to the five-year rule for qualified distributions, the five-year period for conversions begins on the first day of the year of the conversion. However, unlike the five-year rule for qualified distributions, the five-year rule for conversions applies separately to each Roth IRA conversion.

Example 2: In 2018, Jim Bradley, age 41, leaves his job and rolls $60,000 from his 401(k) account to a traditional IRA, maintaining the tax deferral. If Jim decides to withdraw $20,000 next year, at age 42, he would owe income tax on that $20,000 plus a 10% ($2,000) penalty for an early withdrawal.

Instead, in 2019, Jim converts $20,000 from his traditional IRA to a Roth IRA and includes the entire amount converted in income. However, if Jim withdraws that $20,000 in 2019, he also will owe the 10% penalty because he does not meet the five-year rule for conversions; the rationale is that the IRS doesn't want people to avoid the early withdrawal penalty on traditional IRA distributions by making a Roth conversion.

The good news is that, in this example, Jim will have started the five-year clock with his 2019 Roth IRA conversion. Therefore, he can avoid the 10% early withdrawal penalty on the conversion contribution after January 1, 2024, even though he will only be age 47 then. Jim will owe income tax on any withdrawn earnings, though, until he reaches age 59½ or he meets one of the other qualified distribution criteria.

Note that various exceptions may allow Jim to avoid the 10% penalty before the end of the five-year period. Altogether, the taxation of any Roth IRA distributions made before five years have passed and before age 59½ can be complex. If you have a Roth IRA, our office can explain the likely tax consequences of any distribution you are considering. Generally, it is better to wait until the age 59½ and five-year tests are passed before making Roth IRA withdrawals, to avoid taxes.

Trusted Advice
Roth IRA Distributions

- Roth IRA distributions after age 59½ (and five years after you set up and make a contribution to your first Roth IRA) qualify for complete tax-free treatment.

- Distributions that do not qualify for this tax-free treatment may be subject to income tax, a 10% early withdrawal penalty, or both.

- Ordering rules apply to non-qualified distributions.

    - First come regular contributions, rollover contributions from other Roth IRAs, and rollover contributions from a designated Roth account.

    - Next come conversion contributions, on a first-in, first-out basis. The taxable portion comes before the nontaxable portion.

    - Earnings on contributions are the last dollars to come out.