

## Looking at the Choices for Roth IRA Five-Year Withdrawal Rule(s)

By Mary Dean

In 1995 NAPFA presented one of the first day-long IRA seminars. It opened my eyes to the complexity of IRAs, and exposed me to leaders in the field, and resources to help advisors understand these complicated, crucial retirement investments. I still subscribe to those resources today and I recommend that all NAPFA members do so. Despite this wealth of available information, there was still one area that perplexed me: the five-year withdrawal rule(s). It was a maze. Each time I found a path, there was another wall then another and another. One answer did not apply to all clients even within the same age group. Even the leaders in the field told me that they would have to research a particular question before they could be confident that their response was accurate. I felt that there had to be a simpler solution!!

With many of us considering large Roth conversions this year, the five year rule(s) plays a major role in understanding the merit of conversion. Usually we assume that a client would be safe doing a conversion if he or she would not withdraw the money until age 59 ½. But the five year rule(s) may change that simple assumption. What if their heirs need the money and they are not 59 ½? What if the owner needs all the money before 5 years?

The attached diagram shows the basic decision steps for a person with one or multiple Roth conversions, noting both five-year periods, the 10-percent penalty, and income taxes on earnings. The 10-percent penalty applies to the taxable conversion amount when the conversion was made. So for multiple conversions, each has its own five-year period, based on the date of each conversion. For income taxes on earnings, the five-year rule is based on the earliest contribution and/or conversion (and for this situation, the conversion is considered a contribution). As such the five-year rule is valid for the date of the earliest contribution, including conversions.

I decided that I needed a flow chart that would help me to understand when the five-year rules would come into play and who might be affected by it. Putting the complicated rules into graphic form would help me to actually see where situations would lead. I am sharing the flowcharts that I have developed.

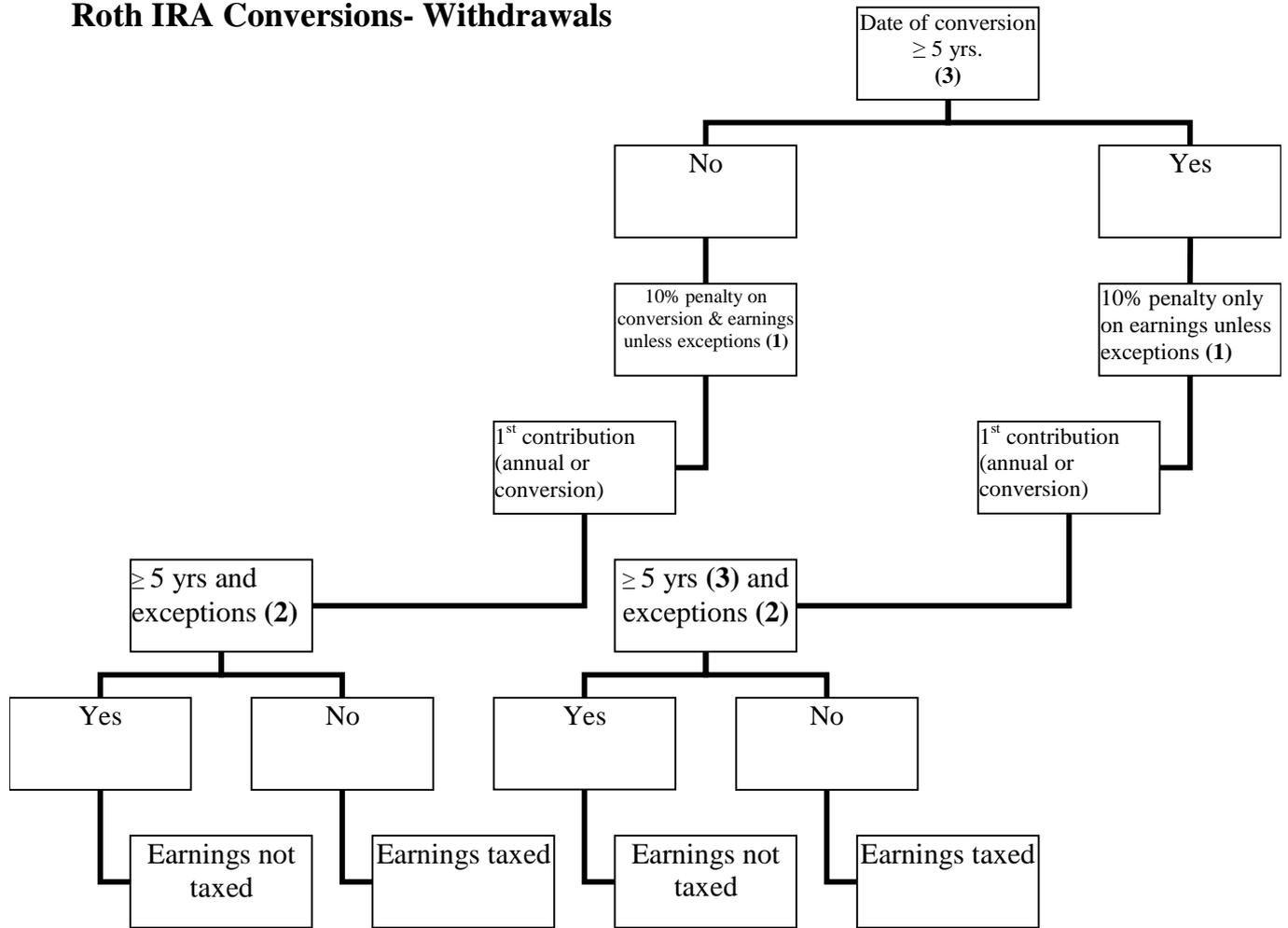
The charts help to show when a Roth conversion might be a good idea and when it might leave a person exposed to negative financial impacts if other needs or situations arise. The charts help us to be cautious and literally to show our clients what they are choosing to do.

To be sure, there are cases where a person younger than 59 ½ might be a good candidate for a Roth conversion. Remember that the original conversion (not earnings) can be withdrawn any time without incurring a tax obligation. The 10-percent penalty applies, but there are many situations in which even the penalty is waived. For those younger than 59 ½, frequently used exceptions would be the first-time homebuyer expenses (limited), unreimbursed medical expenses (the expenses can be for the account owner or plan participant, the spouse, or dependents), and qualified higher-education expenses.

A final note of caution: withholding or paying income taxes from a Roth due to a conversion or cash distribution is considered a withdrawal. The five-year rule(s) applies even if you do not see the cash.

I would like to thank Margot Dorn in my office for her assistance in this project.

## Roth IRA Conversions- Withdrawals

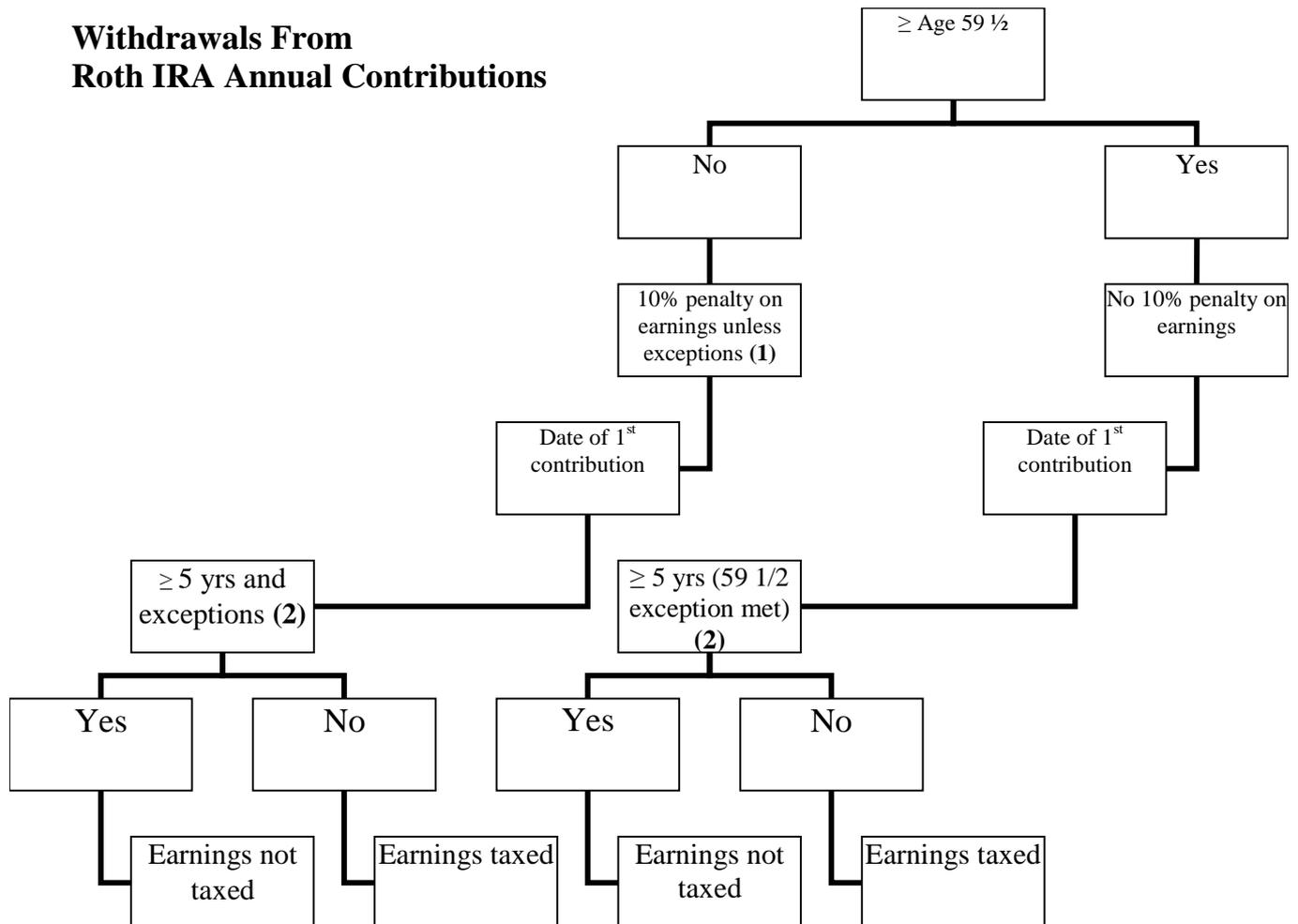


- Date of 1<sup>st</sup> conversion= 1<sup>st</sup> day of accounting year: 4-08 conversion = 1-1-08
- (3) Two 5 year periods: First: 10% penalty on conversion – each has its own 5 year period.  
Second: tax on earnings – begins with 1<sup>st</sup> contribution (annual or conversion)
- Withdrawals considered to come from:
  - 1<sup>st</sup> Contributions = cost basis; no income tax
  - 2<sup>nd</sup> Conversions = cost basis; no income tax; possible 10% penalty on original taxable conversion amount
  - 3<sup>rd</sup> Earnings = possible income tax; possible 10% penalty

Exceptions 10% Penalty (1)	Exceptions Income Tax (2) 1 <sup>st</sup> contribution (annual or conversion) 5 or more yrs PLUS one of the following:
On or over age 59 ½;	On or over age 59 ½;
Death of the Roth IRA owner;	Death of the Roth IRA owner;
Disability of the Roth IRA owner;	Disability of the Roth IRA owner; or
First-time homebuyer expense; or	First-time homebuyer expense
Additional exceptions attached	

Summary: Can withdraw original conversion any time without tax. The 10% penalty may apply but there are many exceptions to the penalty. Earnings will be taxed unless 1<sup>st</sup> conversion was made five or more years ago.

## Withdrawals From Roth IRA Annual Contributions



- ❑ *Two 5 year periods: First:* 10% penalty on conversion – N/A since above only annual contributions. *Second:* tax on earnings – begins with 1<sup>st</sup> contribution (annual or conversion)
- ❑ Withdrawals considered to come from:
  - 1<sup>st</sup> Contributions = cost basis; no income tax
  - 2<sup>nd</sup> Conversions = cost basis; no income tax; possible 10% penalty on original taxable conversion amount
  - 3<sup>rd</sup> Earnings = possible income tax; possible 10% penalty

Exceptions 10% Penalty (1)	Exceptions Income Tax (2) 1 <sup>st</sup> contribution (annual or conversion) 5 or more yrs PLUS one of the following:
On or over age 59 1/2;	On or over age 59 1/2;
Death of the Roth IRA owner;	Death of the Roth IRA owner;
Disability of the Roth IRA owner;	Disability of the Roth IRA owner; or
First-time homebuyer expense; or	First-time homebuyer expense
Additional exceptions attached	

Summary: Can withdraw original contribution any time without tax or penalty. Earnings will be taxed unless 1<sup>st</sup> contribution was made five or more years ago. Also earnings could be subject to the 10% penalty but many exceptions apply.

### **10% Penalty – Roth Distributions – Additional Exceptions -**

Distributions of unreimbursed medical expenses (do not exceed deduction)

- Distributions for medical insurance to unemployed.
- Distributions to pay qualified higher education expenses.
- Distributions made on account of an IRS levy on the Roth.
- Distributions to individuals called to active duty
- Distributions that are part of a series of substantially equal periodic payments
- Certain disaster distributions

### **Additional Notes**

1. The attached conversion flow chart does not consider a case where someone converts in 2010, defers taxes to 2011/2012 then withdraws in 2012. Normally the taxable conversion would be the basis but the full tax has not yet been paid.
2. Income tax withholding is considered a distribution.
3. Recharacterizations are not withdrawals.

## Examples - Five Year Withdrawal Taxes/Penalties

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- A - Has it been at least 5 years since you converted this amount    yes  
Are you over 59 ½    yes  
**NO TAX**  
**NO PENALTIES**
- B - Has it been at least 5 years since you converted this amount    yes  
Are you over 59 ½    no  
Do you meet any of the statutory distribution exceptions  
Death, disability, first home    yes  
Do you meet any of the statutory penalty exceptions  
Death, disability, first home  
Series of substantially equal payments  
Medical expenses greater than 7.5% of AGI  
Health insurance premiums for unemployed  
Higher education expenses    yes  
**NO TAX**  
**NO PENALTY ON EARNINGS**
- C - Has it been at least 5 years since you converted this amount    no  
Are you over 59 ½    no  
Do you meet any of the statutory distribution exceptions  
Death, disability, first home    yes  
Do you meet any of the statutory penalty exceptions  
Death, disability, first home  
Series of substantially equal payments  
Medical expenses greater than 7.5% of AGI  
Health insurance premiums for unemployed  
Higher education expenses    yes  
**TAX ON EARNINGS**  
**NO PENALTY ON EARNINGS**
- D - Has it been at least 5 years since you converted this amount    no  
Are you over 59 ½    no  
Do you meet any of the statutory distribution exceptions  
Death, disability, first home    no  
Do you meet any of the statutory penalty exceptions  
Death, disability, first home  
Series of substantially equal payments  
Medical expenses greater than 7.5% of AGI  
Health insurance premiums for unemployed  
Higher education expenses    yes  
**TAX ON EARNINGS**  
**NO PENALTY ON EARNINGS**

E - Has it been at least 5 years since you converted this amount    no  
 Are you over 59 ½    no  
 Do you meet any of the statutory distribution exceptions  
     Death, disability, first home    no  
 Do you meet any of the statutory penalty exceptions  
     Death, disability, first home  
     Series of substantially equal payments  
     Medical expenses greater than 7.5% of AGI  
     Health insurance premiums for unemployed  
     Higher education expenses    no

**TAX ON EARNINGS**

**PENALTY ON TAXABLE CONVERTED AMOUNTS AND EARNINGS (Q 4:17)**

F - Has it been at least 5 years since you converted this amount    yes  
 Are you over 59 ½    no  
 Do you meet any of the statutory distribution exceptions  
     Death, disability, first home    no  
  
 Do you meet any of the statutory penalty exceptions  
     Death, disability, first home  
     Series of substantially equal payments  
     Medical expenses greater than 7.5% of AGI  
     Health insurance premiums for unemployed  
     Higher education expenses    no

**TAX ON EARNINGS**

**PENALTY ON EARNINGS (Q 4:17)**

G - Has it been at least 5 years since you converted this amount    yes  
 Are you over 59 ½    no  
 Do you meet any of the statutory distribution exceptions  
  
     Death, disability, first home    no  
 Do you meet any of the statutory penalty exceptions  
     Death, disability, first home  
     Series of substantially equal payments  
     Medical expenses greater than 7.5% of AGI  
     Health insurance premiums for unemployed  
     Higher education expenses    yes

**TAX ON EARNINGS**

**NO PENALTY ON EARNINGS**

Notes:

- a) The five year period for conversions starts January 1 of the year during which a conversion was made.
- b) There are several additional (uncommon) exceptions to the penalty rules:
  - Distributions made on account of an IRS levy under Code Section 6331
  - Distributions to individuals called to active duty after September 11, 2001 for at least 180 days or qualified reservist
  - Certain disaster distributions