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Retirement Planning

Quick Answers: The Five-Year Rule and Important Info on Roth IRA Conversions

Here, we round up our responses to some of the most-asked questions about Roth IRA conversions.

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We get questions—and more questions. In this occasional series, we will present "quick answers" to queries we've received from advisors and investors about today's most important retirement topics.

Many investors strategically make a Roth conversion a part of their overall retirement savings strategy. Roth conversions are, in essence, a way to pay income tax at today's tax rates by converting pre-tax retirement assets in exchange for the potential of tax-free withdrawals in retirement. Roth IRAs offer several additional benefits, including no required minimum distributions.

There are several ways to open a Roth IRA. The principal route to IRA ownership is through direct contributions (subject to an annual IRS imposed income threshold). But another important way to establish (or add to an existing) Roth IRA is by converting assets from a traditional IRA (including SEP and SIMPLE IRA) into a Roth IRA.

Here is a compendium of the most-asked questions that we have received regarding Roth IRA conversions.

What is a Roth conversion, and how does it work?

When an IRA owner decides to move all or part of his or her traditional IRA (including SEP and SIMPLE IRAs) assets to a Roth IRA, it is called a conversion. An individual may also roll over a qualified plan account (i.e., 401(k)) and convert such funds into a Roth IRA directly without first opening a traditional IRA. Conversion amounts that represent deductible (pre-tax) contributions and earnings are taxed as ordinary income, whereas after-tax (non-deductible) funds are recovered tax-free.

Who is eligible to make a Roth conversion?

All account owners regardless of age and/or income are eligible to convert traditional IRA funds to a Roth IRA. However, those individuals subject to a Required Minimum Distribution (RMD) (in the year of the conversion) must take their RMD prior to converting funds to a Roth IRA. In other words, an RMD cannot be converted to a Roth account.

Example: Angie, age 75, would like to convert her $100,000 traditional IRA to a Roth IRA. Angie must take her 2024 RMD prior to making a conversion to a Roth IRA.

Can a non-spouse beneficiary convert inherited IRA funds to a Roth IRA?

The answer is tricky. A non-spouse beneficiary who inherits an IRA (traditional, SEP, or SIMPLE) is prohibited from converting those funds to a Roth IRA. In contrast, a non-spouse who inherits a workplace plan account (i.e., 401(k), 403(b)) can convert such funds directly to an inherited Roth IRA.

Example: Tony inherits both a traditional IRA and 401(k) from his cousin who died earlier this year. Tony, a non-spouse beneficiary, cannot convert the inherited (traditional) IRA to a Roth IRA. He can however roll over (convert) 401(k) funds directly to an inherited Roth IRA. Importantly, such funds must be moved directly from the 401(k) to an inherited IRA. Notably, the conversion would subject Tony to income tax for the year of the conversion.

How does the Roth five-year rule work?

One of the biggest benefits of a Roth IRA is the potential for tax-free distributions (including earnings) referred to as a "Qualified Distribution." For such distributions to be qualified, they must be paid to the account owner after age 59½, or in the event that the account owner becomes disabled, or for the purchase of a first home, or a beneficiary after death (of the account owner).

In addition, the five-year hold period must also be satisfied. This holding period begins with the account owner's first Roth IRA contribution or conversion— this five-year period is "locked in" for life. In other words, the holding period does not restart with each contribution or conversion. Furthermore, the hold period applies to funds that are contributed or converted to any Roth regardless of where the account is established.

Example: Kenny made a $2,000 contribution to his first Roth IRA on May 10, 2010. In May 2015, he converts $10,000 from his traditional IRA to his Roth IRA. Then, in 2017, he converts another $25,000 to a new (different) Roth IRA. Kenny's five-year hold period (for all his Roth IRAs) starts with his 2010 contribution. It does not matter that he converted additional funds later to a different Roth IRA. Notably, the five-year holding period begins on January 1 of the year coinciding with Kenny's first contribution or conversion to any of his Roth IRAs. Therefore, Kenny's five-year holding period begins on January 1, 2010 (even though his first contribution was not made until May 10). Kenny satisfies the five-year rule on January 1, 2015.

There is, however, a second five-year rule for certain Roth IRA owners to become familiar. The first one (see Kenny example above) applies to determine whether distributions qualify for tax-free treatment. The second applies solely to distributions of converted funds to those Roth IRA owners who have not reached age 59½.

This five-year holding period (referred to as a "recapture tax") is treated differently than the five-year rule for qualified tax-free distributions. For example, while there is one lifetime five-year hold period to determine if distributions qualify for the tax-free treatment, a new and separate five-year hold period applies to the "recapture tax" for each new conversion. Therefore, when a Roth IRA owner who has not reached age 59½ (at the time of the distribution) distributes converted funds prior to the end of the applicable five-year hold period, a 10% early distribution penalty tax (i.e., "recapture tax") applies.

Example: Jerry, age 50, converted $100,000 from his traditional IRA to a Roth IRA in 2019. In 2022, he converts another $100,000 to his Roth IRA.

In 2024, Jerry takes a distribution consisting of $150,000 of converted funds from his Roth IRA. The first $100,000 will be recovered tax- and penalty-free. However, the remaining $50,000 will be subject to the 10% recapture tax penalty unless Jerry qualifies for an exception. Why? Because his 2022 conversion did not satisfy the five-year holding period. Those funds would satisfy its five-year holding period on January 1, 2027; whereas the first $100,000 satisfied its five-year holding period on January 1, 2024.

Does the five-year rule apply to Roth IRA owners older than age 59½?

Short answer—yes! The five-year rule remains (very) relevant once the account owner attains age 59½. Why? This five-year holding period must still be satisfied if a Roth IRA owner wants tax-free distributions of earnings. As mentioned, a qualified distribution from a Roth IRA requires the owner to be age 59½ and satisfy the five-year holding period.

Example: Maria, age 75, converts $200,000 from her SEP-IRA to a Roth IRA in 2021. In 2024, when her Roth IRA has grown to $225,000, she takes a full distribution thinking it will be tax-free. The first $200,000 will be distributed tax-free. This is because Maria paid taxes on this amount when she converted such funds in 2021. Furthermore, $25,000 (earnings) will also be distributed penalty-free because Maria is over age 59½. However, the $25,000 (earnings) is not a qualified distribution and will therefore be taxable because the five-year rule has not been satisfied. Maria would need to wait until January 1, 2026, to satisfy the five-year holding period and therefore qualify for tax-free treatment.

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How does the five-year rule apply to apply to a non-spouse beneficiary?

A beneficiary of an inherited IRA is not subject to the 10% early withdrawal penalty tax, regardless of the age of either the account owner or beneficiary. However, the five-year holding period does apply when determining if a distribution is qualified for tax-free treatment.

Example: Nick, age 50, inherits a Roth IRA from his mother, who died in 2024. His mother had previously converted her $500,000 traditional IRA in 2021. This was her first and only Roth IRA. Her account is now valued at $520,000.

Should Nick decide to take a full distribution this year (2024), he will be subject to income tax on $20,000 (earnings). However, the $500,000 in previously converted funds will be distributed tax- and penalty-free, even though it has been less than five years since funds were converted. This is because the 10% early distribution penalty tax does not apply to beneficiaries. However, the five-year rule has not been satisfied. Nick's mother opened her (first and only) Roth IRA (via conversion) four years earlier—in 2021. Therefore, $20,000 in earnings will be taxable (federal and state, if applicable). Nick must wait until January 1, 2026, to distribute the earnings tax-free. Notably, Nick gets the benefit of "absorbing" his mother's (i.e. Roth IRA owner's) five-year hold time.

How does the five-year rule apply to apply to a spouse beneficiary?

A spouse beneficiary, like a non-spouse beneficiary, must also satisfy the five-year holding period to qualify for tax-free distributions. However, if they do a spousal rollover, they are allowed to use the more beneficial five-year hold period that applies to their own Roth IRA (assuming they have one) or the Roth IRA inherited from their spouse.

Example: Tommy and Gina are married. Tommy, age 60, has held his Roth IRA for seven years. His Roth funds are therefore "qualified" and can be distributed tax-free.

Tommy dies in 2024. Gina, age 62, is the sole beneficiary. She elects to roll the Roth funds to a new Roth IRA in her name. This serves as Gina's first and only Roth IRA. All distributions from Gina's Roth IRA will be tax-free, even though she has not held her own Roth IRA for five years at the time of the distribution. Why? The rules allow for Gina as a spousal beneficiary to treat Tommy's five-year hold time as her own.

Who is responsible for tracking the five-year holding period for Roth IRA distributions?

It's crucial for both a Roth IRA owner and their beneficiary to track their track account activity. This tracking determines whether (or not) the five-year hold per period has been met. Oversight is best accomplished by reviewing IRS Form 5498 (2024 Form 5498 (irs.gov)); generated annually by the IRA custodian. This form essentially serves as an annual report of all IRA activity including Roth IRA contributions and conversions. Notably, there is no requirement for a taxpayer to report their Roth IRA contribution on their federal tax return.

An IRA custodian, may signify whether the five-year holding period has been satisfied upon a distribution being taken, via IRS Form 1099-R *"Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc."*

Does the addition of the converted (taxable) amount to an individual's income affect his or her eligibility to make a Roth IRA contribution?

No. Increasing an individual's household income due to a Roth conversion does not affect one's eligibility to make Roth IRA contributions. In other words, an individual that is income qualified (to make a Roth IRA contribution), prior to a conversion, would remain eligible post conversion.

Questions? Please contact your Lord Abbett representative at 888-522-2388.

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A 401(k) plan is a qualified plan that includes a feature allowing an employee to elect to have the employer contribute a portion of the employee's wages to an individual account under the plan. The underlying plan can be a profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan. Generally, deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reported as taxable income on the employee's individual income tax return. A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but, among other things, it must provide for employer contributions that are fully vested when made.

A Roth IRA is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years, and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax-deductible, but withdrawals during retirement are generally tax-free.

A SIMPLE IRA is a retirement plan that may be established by employers, including self-employed individuals. The employer is allowed a tax deduction for contributions made to the SIMPLE. The employer makes either matching or nonelective contributions to each eligible employee's SIMPLE IRA, and employees may make salary deferral contributions.

A Traditional IRA is an individual retirement account (IRA) that allows individuals to direct income, up to specific annual limits, toward investments that accumulate tax-deferred. Contributions to the traditional IRA may be tax-deductible depending on the taxpayer's income, tax-filing status, and other factors.

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