Understanding the Roth IRA “Five-Year Rule”

Todd Gebhardt, Director of Tax Services, Commerce Trust

The Roth IRA is a unique investment vehicle that offers significant tax advantages for long-term investors with the ability to defer distributions of accrued income and gains. Roth contributions are taxed upfront, so the money investors contribute to their accounts generally can be withdrawn without the worry of taxes or penalties. However, it’s a different story for investment income generated from those contributions.

There are requirements regarding Roth IRA withdrawals of earnings or “qualified distributions.” The first is age-based, which requires earnings generally cannot be withdrawn by the account owner before age 59½.

The second rule requires owning the account for at least five years to avoid taxes or penalties on Roth earnings. Known as the five-year rule, these stipulations often supersede the age requirement and can cause investors confusion, or worse, an adverse and costly consequence to one’s retirement strategy.

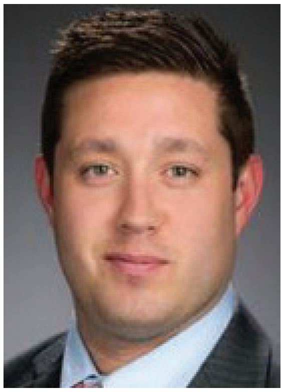
How Does the Roth IRA Five-Year Rule Work?

There are generally three types of five-year rules investors should understand.

- **First Contribution** — The five-year period starts on the first day of the tax year for which an investor makes an initial contribution to a Roth IRA. For example, if a participant contributes to an account for the first time during the 2023 tax year, the five-year period will end on Jan. 1, 2028.
- **Inherited Roth IRAs** — The first contribution five-year period also applies to a Roth IRA that a participant might inherit. So, if it’s been less than five years since the original owner made an initial Roth contribution, the earnings are taxable.
- **Roth Conversions** — Another type of five-year rule applies when investors convert other retirement accounts, such as a 401(k), into a Roth IRA. Like the first contribution provision, the five-period starts on the first day of the tax year of the conversion. However, this rule is slightly different in that each Roth conversion starts its own five-year clock.

At Commerce Trust, *we understand the complexities of Roth IRA withdrawals and how they fit into the retirement lifestyles our clients want. Contact Commerce Trust today to learn more about how we can help you achieve your financial goals.*

Source: CCH AnswerConnect, Wolters Kluwer; Internal Revenue Service.



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Todd is the director of tax services for Commerce Trust Company. In addition to tax planning and consulting services to that client base, his group annually prepares more than 120 returns for charitable trusts and private foundations and more than 350 returns for individual, estate, gift, trust, and partnership clients of Commerce Trust. Todd also co-manages Commerce Trust's annual tax return preparation process, including reviewing and maintaining Commerce Trust's accounting system and the integration of this system with the organization's external vendor. Todd earned his Bachelor of Science in accounting from Maryville University of St. Louis.