

## THE FIVE YEAR ITCH

[Marcia Chadwick Holt](#)

A Quiz for you. The Five-Year Rule which applies to distributions from a Roth IRA is measured from:

1. The December 31st of the year of death of the owner of the Roth IRA
2. The date on which the owner first made a contribution to a Roth IRA
3. The date on which the owner rolled over or converted a Traditional IRA to a Roth IRA
4. All of the above.

Did you choose (4)? Hooray, you win. There's no prize except the knowledge that you found your way through the maze of Code sections and regulations thereunder and arrived at the correct answer. There are three different Five-Year Rules applicable to Roth IRAs. Each rule is measured from a different date.

As we all know too well, the rules governing distributions from Qualified Plans and IRAs are much too complex. Individuals seek advice because they can't understand the rules. Attorneys, trust officers and other advisers must explain the rules in simple terms. But, how do we explain three different Five-Year Rules in simple terms? Or better yet, why must we deal with such complexity? The latter question I ask our lawmakers and regulation writers. I hope they recognize the need for simplicity in the lives of our clients and customers. Many of our clients and customers can't begin to understand three different Five-Year Rules for just one Roth IRA.

Now, back to an explanation of the three Five-Year Rules a/k/a the Five Year Itch.

### The First Five-Year Rule

The first Five-Year Rule applies to all distributions from a Roth IRA after the owner's death.<sup>1</sup> It determines when minimum required distributions (AMRDs<sup>2</sup>) must be made to beneficiaries. After the death of the IRA owner, the entire interest must be distributed by December 31st of the year which contains the 5th anniversary of the owner's death.<sup>3</sup>

No discussion of this first Five-Year Rule is complete without a discussion of exceptions to the rule. The proposed regulations governing Roth IRAs provide that the post-death minimum distribution rules under Code ' 401(a)(9)(B) that apply to Traditional IRAs also apply to Roth IRAs with the exception of the at-least-as-rapidly rule described in Code ' 401(a)(9)(B)(i).<sup>4</sup> Consequently, the exceptions to the Five-Year Rule apply.

There is a Alife or life expectancy exception<sup>5</sup> for payments which begin not later than December

31st of the calendar year after the death of the owner and which are paid over the life of the Designated Beneficiary or over a period not extending beyond the life expectancy of the Designated Beneficiary. These distributions are also excepted from the additional 10% income tax under IRC ' 72 (t). But, make sure the distributions begin by December 31st of the calendar year after the death of the participant! Otherwise, the Five-Year Rule and not the exceptions applies.

There is also an exception to the Five-Year Rule if the sole beneficiary is the decedent=s spouse. Payments may be made over the life of the spouse or over a period not extending beyond the spouse=s life expectancy provided that payments begin by the later of:

1. The December 31st of the calendar year immediately following the death of the owner; or
2. The December 31st of the calendar year in which the owner would have attained age 702.

Note, however, that if a trust is named as beneficiary, distributions must begin by December 31st of the calendar year immediately following the death of the participant even if the spouse is treated as the Designated Beneficiary. Distributions may NOT be postponed until the December 31st of the year in which the participant would have reached age 702.

To add to the confusion, if the surviving spouse is the Designated Beneficiary and dies after the participant but before distributions have commenced, the Five-Year Rule and the exceptions to the Five-Year Rule apply as if the surviving spouse were the participant. In addition, the surviving spouse may treat the Roth IRA as his or her own. If the surviving spouse does so, no MRDs are required during the spouse=s lifetime and the Five-Year Rule applies at the surviving spouse's death.

Which rules apply? It isn=t enough just to know the rules. You have to read the IRA because the terms of the Roth IRA will always control. These terms may be more strict than the rules. For example, the IRA may provide that if the surviving spouse is the sole beneficiary, the surviving spouse is automatically treated as the new owner so that neither the Five-Year Rule nor its exceptions apply because of the death of the deceased spouse.

Why should you care? Because failure to comply with the first Five-Year Rule or its exceptions can lead to a 50% excise tax. A 50% excise tax is imposed on the difference between the MRD and the actual distribution during the taxable year if the beneficiary withdraws less than the MRD. This can be an expensive mistake.

### The Second Five-Year Rule

A second Five-Year Rule also applies to Roth IRAs. It determines when earnings may be distributed from the Roth IRA free of income tax. As background, contributions to a Roth IRA are not deductible and withdrawals of contributions are not subject to income tax. However, withdrawal of earnings are tax free only if the distribution is a Qualified Distribution.

There are two requirements for a Qualified Distribution and one of the requirements is the second Five-Year Rule:

3. A Roth IRA must be held for 5-taxable years before any earnings can be withdrawn free of income tax (A Five-Taxable-Year Period). This second Five-Year Rule is measured from the first-taxable

year for which the individual made a contribution to a Roth IRA. Once the Five-Taxable-Year Period has been satisfied, any distribution from a Roth IRA is excludable from income tax, even one allocable to contributions made within five years before the distribution. Also, if a surviving spouse treats the Roth IRA as his or her own, the Five-Taxable-Year Period ends on the earlier of the deceased spouse=s or the surviving spouse=s Five-Taxable-Year Period. Furthermore, a Five-Taxable-Year Period is not redetermined when the Roth IRA owner dies. The beneficiary can count the decedent=s holding period as his or her own. Because of the Five-Taxable-Year Period, no Qualified Distributions can occur before taxable years beginning in 2003.

4. A Qualified Distribution must be a distribution which is made:
  1. To the owner after he or she reaches age 59 1/2,
  2. To a beneficiary because of the owner=s death,
  3. To the owner after he or she is disabled, or
  4. To the owner for a qualified first-time home purchase of up to \$10,000 lifetime. The distribution must be used within 120 days of the distribution for the Aqualified acquisition costs@ of acquiring a Aprincipal residence@ for a Afirst-time homebuyer who is the owner, his or her spouse or a descendant or ancestor of either.

Why should you care? All distributions which are not Qualified Distributions, are subject to income tax on earnings and the 10% penalty tax unless an exception applies under IRC ' 72(t)(2).

### The Third Five-Year Rule

A third Five-Year Rule also applies to Roth IRAs. It determines when distributions from Roth IRAs are subject to the 10% penalty tax. As background, amounts withdrawn from a Roth IRA are treated as made in the following order:

5. From regular contributions.
6. From conversion contributions on a first-in first-out basis. Distributions allocated to a qualified rollover or conversion contribution are treated as coming first from the taxable portion of the contribution or conversion.
7. From earnings.

The 10% penalty applies to income withdrawn as well as to withdrawals of certain rollover contributions unless an exception applies under IRC ' 72(t)(2). Any amount rolled over or converted from a Traditional IRA to a Roth IRA which is withdrawn before the Five-Taxable-Year Period is subject to the 10% penalty tax (unless an exception applies) to the extent that the amount distributed would have been taxable if it had been distributed from a Traditional IRA and not rolled over or converted. This third Five-Year Rule is measured from the taxable year in which the rollover or conversion occurred. The second Five-Year Rule measuring the Five-Taxable-Year Period beginning with the first year for which the taxpayer made a Roth contribution does not apply.

To comply with the third Five-Year Rule, a taxpayer who is under age 59 1/2 must keep a record of the date and amount of all rollovers or conversions.

For example: Jane is 40 years old. She rolls over \$50,000 to a Roth IRA in year 1 from a Traditional IRA. The rollover represents \$20,000 in earnings included in her income and \$30,000 of nondeductible contributions. She withdraws \$15,000 to buy a car in year 2. Under the ordering rules, the withdrawal is attributable to amounts includible in income due to the

conversion. Since the \$15,000 is withdrawn within the Five-Taxable-Year Period beginning with the year in which the IRA was converted to a Roth IRA, the \$15,000 withdrawal is subject to a 10% penalty tax of \$1,500. It should be noted that Jane would have been better off withdrawing from a Traditional IRA since the amount withdrawn would have been a pro-rata portion of her nondeductible contributions which are not taxable and earnings which are taxable.

However, a taxpayer who is age 59 1/2 or older does not need to keep a record of the date and amount of rollovers and conversions. Such a taxpayer can withdraw all rollovers as Qualified Distributions as long as Five-Taxable-Years have passed beginning with the first year for which the taxpayer made a Roth contribution, that is, the second Five-Year Rule applies. Since the taxpayer is 59 1/2 or older, there is no 10% penalty tax, that is, the third Five-Year Rule does not apply. IRC ' 408A(d)(2).

For example: Bob rolls over \$20,000 to a Roth IRA in year 1. He rolls over \$60,000 in year 5. He withdraws \$70,000 in year 6 when he is 59 1/2 . The withdrawal is a tax-free Qualified Distribution since the Five-Taxable-Year Period is satisfied and he is over age 59 1/2.

Why should you care? Because distributions attributable to certain rollovers or conversions are subject to a 10% penalty tax unless an exception applies.

The second Five-Year Rule and the third Five-Year Rule and their exceptions are best summarized in the following chart:

	<u>Roth IRAs</u>					
	<u>Held Less Than Five-Taxable-Year Period *</u>			<u>Held More Than Five-Taxable-Year Period *</u>		
	Tax on Principal	Tax on Earnings	10% Penalty Tax	Tax on Principal	Tax on Earnings	10% Penalty Tax
Ayes@ means taxable Ano@ means nontaxable						
1. Age 59 1/2 or later. IRC ' 72(t)(2)(A)(i)	no	yes	no	no	no	no
2. Before age 59 1/2 but not because of a through h below.	no	yes	yes	no	yes	yes
a. Death of Owner. IRC ' 72(t)(2)(A)(ii)	no	yes	no	no	no	no

b. Disability of Owner. IRC ' 72 (t)(2)(A)(iii)	no	yes	no	no	no	no
c. Series of substantially equal periodic payments. IRC ' 72(t) (2)(A)(iv)	no	yes	no	no	yes	no
d. Medical expenses deductible under IRC ' 213. IRC ' 72(t)(2) (B)	no	yes	no	no	yes	no
e. Health Insurance premiums for unemployed individuals. IRC ' 72(t)(2)(D)	no	yes	no	no	yes	no
f. Qualified higher education expenses. IRC ' 72(t)(2)(E)	no	yes	no	no	yes	no
g. Qualified first time home purchase. IRC ' 72(t)(2)(F)	no	yes	no	no	no	no
h. Levy under IRC ' 6331 after 12/31/99. IRC ' 72(t)(2)(A)(vii)	no	yes	no	no	yes	no

\* Any amount which is rolled over or converted from a Traditional IRA to a Roth IRA and which is distributed from the Roth IRA within the Five-Taxable-Year Period beginning with the taxable year in which the rollover or conversion was made is subject to a 10% penalty tax unless an exception applies. IRC ' 408(A)(d)(3)(F). For any other amount which is distributed from a Roth IRA, the Five-Taxable-Year Period is measured differently, that is, from the first-taxable year for which the individual made a contribution to a Roth IRA unless a surviving spouse treats the Roth IRA as his or her own. In that case, the Five-Taxable-Year Period ends on the earlier of the decedent=s or the spouse=s Five-Taxable-Year Period. Prop Reg ' 1.408A-6, Q&A 7.

## SUMMARY:

In summary, there are three Five-Year Rules which apply to distributions from Roth IRAs. With some exceptions, each five year period is measured from a different date: the owner's death, the owner's first contribution, or the owner's rollover or conversion. Since compliance with the rules governs the tax

consequences of distributions, it is important that attorneys, trust officers and other advisers recognize that the five-year-period is measured differently under each of the rules.

## ENDNOTES