5-Year Rule #1. This rule is used to determine if income when withdrawn from a Roth IRA will be tax free or will it be taxable. Remember, under the Roth distribution ordering rules, the income is distributed only after all of the contributions have been distributed, and the conversion contributions are distributed only after all of the annual contributions have been distributed. The conversion contributions are also withdrawn under a first-made-first-out rule.

Illustration #1. Jane, age 60, established her first Roth IRA with ABC Bank on March 15, 2010 for tax year 2009 and she contributed $6,000. On June 15, 2011, she made her first Roth IRA conversion contribution of $43,000. On September 8, 2012, she made her second Roth IRA conversion contribution of $65,000. On April 15, 2013, she made another annual contribution of $6,000 for tax year 2012. She has made total contributions of $120,000 and $35,000 of earnings.

Any distribution to Jane after December 31, 2013, will be qualified and tax-free as her 5-year period ends on December 31, 2013. Her 5-year period commenced on January 1, 2009, and it will be met as of December 31, 2013. This means any distribution to her on or after January 1, 2014 will be qualified an will be tax-free. Under the ordering rules, her contributions would be distributed first and they would be tax-free as they are never taxable. If she would withdraw the *earnings (currently $35,000 and certainly could be more in the future*) such amount will be tax-free. Also note, that after Jane's death, any payment to her beneficiary(*ies*) will also be qualified and tax-free.

5-Year Rule #2. This rules is used to determine if the 10% additional tax will apply to an individual who did a conversion when they were younger than age 59½ and then later takes a distribution comprised of their converted Roth IRA funds.

Illustration #2. David, age 45, established his first Roth IRA with ABC Bank on March 15, 2008 for tax year 2007 and he contributed $6,000. On June 15, 2008, he made his first Roth IRA conversion contribution of $43,000. On September 8, 2010, he made his second Roth IRA conversion contribution of $65,000. On April 15, 2011, he made another annual contribution of $6,000 for tax year 2010. He had made total contributions of $120,000.

The earnings within his Roth IRA as of December 31, 2008 are $5,000; as of December 31, 2009 are $24,000; as of December 31, 2010 are $32,000; as of December 31, 2011 are $45,000; as of December 31, 2012 are $58,000; as of April 10, 2013 are $65,000; and as of September 15, 2013 are $60,000.

David doesn't qualify for a qualified distribution until he attains age 59½ or he is disabled. It is assumed he no longer qualifies as a first-time home buyer. He has taken the following distributions with the following tax consequences.

On December 5, 2011, he withdrew $12,000 from his Roth IRA. Under the Roth distribution ordering rules, annual contributions are distributed first and therefore he owed no income tax for 2011 since he had withdrawn his own annual contributions.

On March 10, 2012, he withdrew $30,000 from his Roth IRA to repay a loan. Under the ordering rules, the $30,000 is considered to have come from the conversion he made on June 15, 2008. Since he had not met the 5-year rule, he owed the 10% additional tax on the $30,000 or $3,000 for 2012. No income tax was owed on the $30,000 since he paid tax on it in 2008.

On April 10, 2013, he withdrew $17,000 from his Roth IRA to pay another loan. Under the ordering rules, the $17,000 is also considered to have come from the conversion he made on June 15, 2008. Since he had met the 5-year rule, he does not owe the 10% additional tax on the $17,000 for 2013. No income tax is owed on the $17,000 since he paid tax on it in 2008. On September 15, 2013, he withdrew the remaining $125,000 from his Roth IRA to make what he believed to be a fantastic investment. Under the ordering rules, the first $65,000 comes from his second conversion which he had made on September 8, 2010. Since he had not met the 5-year rules with respect to the conversion of $65,000, he will owe the 10% additional tax on the $65,000 or $6,500 for 2013. No income tax is owed on the $65,000 since he paid tax on it in 2010. With respect to the $60,000, he will pay tax on his amount at his marginal tax rate plus he will owe the additional 10% tax of $6,000 as he is younger than age 59½. Conversion he made on June 15, 2008. Since he had met the 5-year rule, he does not owe the 10% additional tax on the $17,000 for 2013. No income tax is owed on the $17,000 since he paid tax on it in 2008.

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