IRAs hold over 27% of all retirement plan assets in the United States. People are and should be writing about IRAs. Some articles, including brochures, will sometimes contain errors. A certain investment firm has recently sent a fax to some financial institutions discussing Roth IRAs and some incorrect statements were made. Your institution may have been sent the fax.

November and December are month when some traditional IRA owners decide they are going to do a Roth IRA conversion. Within this article we do not directly name the investment firm, but it is a major firm. The main error within the article is to state that there is always a separate 5-year time period for each distinct Roth IRA conversion contribution.

Why this newsletter article? Many times a CWF client will call us and ask, “why does this article state the tax rules differently than what you have previously told us?”

CWF’s answer is, let us review what you are reading and let us make a determination if we are wrong in our understanding of the tax rules or if the investment firm is wrong?

There are actually two 5-year rules which may apply to a Roth IRA distribution. You, your customer, and their advisors want to understand both rules.

The first 5-year rule relates to whether the distribution of income from a Roth IRA will be taxable or not taxable. There is only one 5-year time period for this 5-year rule.

The second 5-year rule relates to whether a person who is under age 59½ when he or she does a conversion will owe the 10% additional tax if he or she takes a subsequent withdrawal from the Roth IRA before he or she has met a second 5-year requirement. For this purpose, there is a 5-year time period determined for each conversion. When a person under age 59½ does a conversion, he or she does NOT owe the 10% additional tax as If there was no requirement to leave the converted funds in the Roth IRA for a certain time period after the conversion, any person under age 59½ who wanted to take money from his or her traditional IRA would first convert it to a Roth IRA and then take the distribution from the Roth IRA to avoid the 10% tax.

The lawmakers could have decided on any time period: 3-years, 6-years, 10-years, but 5-years was selected. Having two different 5-year rules is confusing.

The 10% additional tax is not owed by a person who has done a conversion once he or she attains age 59½ or meets the 5-year rule with respect to that particular conversion. For example, a person who is age 57 at the time of the conversion is subject to the 5-year rule and also the 10% additional tax for any distribution he or she would take between age 57 and 59½. The 10% tax is not owed once a person attains age 59½.

Below are various incorrect statements made in the article:

1. “Unlike the 5-year rule that applies to contributions, the 5-year rule applies to each conversion separately; each conversion has it’s own 5-year waiting period before a qualified distribution may occur.” These two statements are categorically incorrect.

   Error #1. The 5-year rule does NOT apply to each conversion separately. Reg. 1.408A-6, Q/A-2 provides there is only one 5-year period for both annual and conversion contributions. The IRS regulation provides, "The 5-taxable year period begins on the first day of the individual's tax year for which the regular contribution is made to any Roth IRA of the individual or, if earlier, the first day of the individual's tax year in which a conversion is made to ANY Roth IRA of the individual. The 5-taxable year period ends on the last day of the individual's fifth consecutive tax year beginning with the tax year discussed in the preceding sentence."

Error #2. The article states the 5-year rule applying to "annual" contributions is different from the 5-year rules applying to a conversion contribution. The regulation indicates the 5-year period may be different, but it need not be. For example, a conversion made on December 2, 2013, means the 5-year period begins on January 1, 2013 whereas an annual contribution made on March 1, 2014, for 2013 will also have a 5-year period which begins on January 1, 2013.

2. "Recharacterization is only available in connection with converting amounts into a Roth IRA. It is not available for conversions within a qualified plan." This is not well-written. It is true a qualified plan participant who converts taxable funds into a Designated Roth account cannot recharacterize such conversion. However, the first sentence is wrong because a person is permitted to recharacterize an annual contribution by going from a traditional IRA to a Roth IRA or going from a Roth IRA to a traditional IRA.
3. The statement is also made that "IRA conversions can be recharacterized up to October 15 of the year following the conversion." Not everyone qualifies for this extended deadline. The actual law is, a person has until April 15 of the following year to recharacterize a contribution (*be it a conversion or an annual contribution*). However, if a person filed his or her tax return by April 15 and paid any tax owing, then he or she is given until October 15 to complete the recharacterization.

CWF's explanation is consistent with IRS guidance as set forth in the Regulation 1.408(A) and IRS Publication 590. See Q&A's 2 and 5 of the regulation.

Any article on Roth IRA distributions should explain that the law mandates that distributions come out in the following order: annual contributions, the conversion contributions in order of time (*oldest come out first*), and then earnings come out last. A person never owes income tax when he or she withdraws a *contribution (annual contribution or a conversion contribution*) because such contributions were made with after-tax funds. A person never owes income tax when he or she withdraws the income or the earnings and the distribution is "qualified." A person does owe income tax on the earnings when he or she withdraws the earnings and the distribution is NOT qualified (*e.g. not 59½ or 5-year rule not met*). And if this person is under age 59½, he or In summary, the investment firm's Roth IRA article contains a number of errors. In 1999 the law was changed so that there is only one 5-year time period for purposes of determining whether nor not a Roth IRA distribution is qualified (*tax-free*) or not. Believe it or not, everyone should congratulate the lawmakers as they did try to simplify the tax calculation. The original law effective only for 1998 would have required a person to have separate 5-year time periods for Roth IRA conversion contributions versus annual Roth IRA contributions for purposes of whether the income was taxable or not.