Motley Fool's *Rule Your Retirement* Newsletter

How to Shield Your Roth from Taxes and Penalties

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Last month, I celebrated my 17-year "Fooliversary" (as we call anniversaries around here). Yes, it's been almost two decades since I traded in the suits and ties of my financial advisor job for a motley jester cap (every new Fool employee gets one).

When you've been writing about financial planning as long as I have, you find yourself repeating certain phrases. If the topic at hand is Roth retirement accounts, then some version of this phrase will likely appear (as it did in this 2005 article): "With the Roth, contributions aren't tax-deductible, but withdrawals are tax-free (as long as you follow the rules)."

I throw in that phrase about the rules because they can get rather complicated, and I generally don't get into the nitty-gritty because most long-term investors will satisfy the requirements.

This article, however, is all about those rules.

Two Ways You Might Pay

There are actually two ways that Uncle Sam can grab your Roth gains:

1. **Taxes:** Running afoul of the rules can make your *gains* (but not the contributions) taxable at your ordinary income tax rate (i.e., your tax bracket).
2. **Penalties:** Another set of rules could make your *gains* or *conversions* (but not contributions) subject to a 10% penalty.

The key to avoiding taxes and penalties: Don't touch the investment growth in the account until withdrawing it would be considered a "qualified" (in IRS-speak) distribution. Very generally, a withdrawal is qualified if the account has been open for five calendar years and the account holder is age 59 ½. But as you'll soon read, there are many exceptions, depending on the type of Roth. Some exceptions could allow you to get at least some money tax- and penalty-free sooner than that; others might mean you should leave the money in longer.

So get yourself a cup of a caffeinated beverage and settle in to learn the three keys to keeping Uncle Sam from grabbing your Roth-produced profits.

1. Contributions Are Always Tax- and Penalty-Free

To be able to contribute to a Roth account, you first have to earn money from doing a job. Then you have to pay income taxes on that money. What's left over can be contributed to the Roth (subject to the annual limits). Because you pay income taxes on the money before it goes into a Roth, contributions are considered *after-tax* money. Generally speaking, Uncle Sam taxes money only

once. Thus, the money you contribute to a Roth account will come out free of taxes and penalties, regardless of your age or how long the account has been open.
However, there are important differences between a Roth *IRA* and a Roth *401(k)* in terms of what comes out of an account first.

- **Roth IRA:** The first money to come out of a Roth IRA is the money you contributed. Example: Let's say you're 45 years old, and you contribute $5,000 to a new Roth IRA. A year later it has grown to $7,000. You can withdraw the $5,000 contribution and not worry about any immediate consequences. But if you took out the earnings (i.e., the amount above $5,000 in this example), you'd likely owe taxes and a 10% penalty on that amount.
- **Roth 401(k):** Withdrawals are a proportional mix of contributions and earnings, with any taxes and penalties being assessed against the earnings only. Assume the same particulars as the previous example, except that you take out $3,500. Since that's half the account, half of the withdrawal would be considered a return of your contribution (and not taxed or penalized) while half would be considered earnings (taxed and penalized!).

2. Obey the 5-Year Rules

Generally, you must have had a Roth account open for five years for withdrawals of earnings to be considered qualified. But five years in IRS time is different than five years in normal time.

The clock begins ticking on Jan. 1 of the year the account is considered opened, regardless of the date you actually sent in the money. Because you have until the tax-filing deadline (usually April 15) of the year following any given tax year to make a contribution to a Roth IRA, the five-year rule actually could require that you hold your assets within the Roth IRA for less than *four* years. For example, if you opened your first Roth IRA on April 15, 2013, and made a contribution that counted toward the 2012 tax year, then the effective start date is Jan. 1, 2012, and thus your five years are up on Jan. 1, 2017.

As if that weren't confusing enough, each type of Roth account has its own twists to the five-year rule.

- **Contributory Roth IRAs:** The five-year clock starts the year you open your very first Roth IRA, and that clock applies to all Roth IRA accounts opened thereafter (not including conversions). This also means that if you're 57 when you contribute to your very first Roth IRA, you have to wait until you're 62 to access the earnings without paying taxes (though after age 59 ½, the 10% penalty won't apply).
- **Contributory Roth 401(k)s:** Each account has its own five-year clock. If you opened a Roth 401(k) with one employer when you were 54 and then switched jobs and opened another at age 58, the assets in your first Roth 401(k) can be distributed tax-free after age 59 ½. But you'll have to wait until you're 63 to tap the assets in the second without taxes -- though you might be able to get around that by rolling over the account to a Roth IRA that's been open for five years. Which brings us to ...
- **Roth rollovers:** As suggested in the previous bullet point, if you roll over a Roth 401(k) to an existing Roth IRA, the five-year clock for that IRA is what's used to satisfy the rule. What if you don't have any existing Roth IRAs, and you have to open a new one in order to receive the rollover from a Roth 401(k)? That starts a whole new five-year clock ... even if the Roth 401(k) had been open for several years!
- **Roth Conversions:** If a distribution of a converted amount is done within five years of the conversion and the owner is younger than 59 ½, the distribution will trigger a 10% penalty. Each receives its own five-year clock. However, once the account owner reaches age 59 ½, the 10% penalty will no longer apply to converted amounts, even if it's been less than five years since the conversion.
- **Inherited Roths:** The original five-year clock gets inherited along with the assets. However, the person inheriting the IRA must begin taking required minimum distributions (RMDs) in the year

following the death of the original owner. No 10% penalty applies, but taxes do apply to any earnings contained in the distributions until the five years have elapsed. After that, all withdrawals are tax- and penalty-free.

3. Know When Early Withdrawals Are Exempt From Penalties

There are several exemptions to the 10% penalty for withdrawals made before age 59 ½. Some apply to both IRAs and 401(k)s, some apply to just one or the other.

Here's a list of the most common ones, as well as which types of accounts make the exception available. If you're considering one of these exceptions, first make sure to read up on all the details. Not following the rules can result in the 10% penalty being assessed.

Note also that these exemptions are also available with traditional retirement accounts. Whether the account is a Roth or traditional, these exemptions can spare you from paying the 10% penalty but do *not* change whether you'll owe taxes.

Exception	Applies To…
Total and permanent disability	Both types of accounts
Distributions due to death	Both types of accounts
Substantially Equal Periodic Payments, a.k.a. 72(t)	Both types of accounts
Unreimbursed medical expenses that exceed 10% of adjusted gross income (7.5% if 65 or older)	Both types of accounts
Active reservists on duty at least 180 days	Both types of accounts
Distributions from inherited accounts	Both types of accounts
Higher education, for self or qualified relatives	IRAs only
“First-time” home buyer, up to $10,000 per account owner (can be used for qualified relatives, or for yourself if you didn’t own a home in the previous two years)	IRAs only
Distributions used by unemployed persons to pay for health insurance	IRAs only
Left job at age 55 or later	401(k)s only
Loan from 401(k) with current employer	401(k)s only
Payments made under qualified domestic relations order	401(k)s only
Distribution of dividends from employee stock ownership plan	401(k)s only