

Roth IRA Beneficiaries Must Mind the Five-Year Clock Too: The Tax and Penalty Implications for Inherited Roth IRA Withdrawals

Our ERISA consultants on the Columbia Management Learning Center Resource Desk have been answering an increasing number of calls from financial advisors who have specific questions about Roth IRAs and the tax implications for their clients and their clients' beneficiaries. Through our relationship with the Columbia Management Learning Center, we regularly guide Columbia Management's financial advisor partners through the rules and regulations that apply to Roth IRA distributions. A recent call with a UBS financial advisor in Virginia is representative of a typical question on this subject. The advisor queried the following.

A parent converts money to a Roth IRA and dies before the Roth has existed for five years. The beneficiary (his daughter) elects to take required minimum distributions (RMDs) over her life expectancy. What tax treatment applies to the Roth IRA distributions for the beneficiary?

Highlights of Recommendations

The IRS has prescribed a distribution hierarchy for Roth IRA assets.

- Contributions are always considered as taken first.
- Conversions (if any) are second in order of disbursement by year of conversion, with converted pre-tax assets taken first and converted after-tax assets taken second.
- Earnings are considered distributed last.

The following tax treatment applies to Roth IRA withdrawals.

- Contributory dollars are always distributed on a tax- and penalty-free basis.
- Converted pre-tax assets are always distributed on a tax-free basis, but may be subject to an early withdrawal penalty, unless they have been held in the account for five years or a penalty exception applies (such as death, as would be the case here).
- Converted after-tax assets are always distributed on a tax- and penalty-free basis.
- Distributed earnings are taxable and may be penalized *unless two conditions are met*. First, the Roth IRA must have been in existence for at least five years. Second, the owner must be either age 59 ½ or older, disabled, using the amount for a first-home purchase or deceased. When a beneficiary is the withdrawal recipient, the amount of time the Roth IRA was held by the deceased owner counts towards fulfilling the five-year period for determining taxability of earnings.)

Consequently, in this scenario, distributions of any contributory and conversion assets to the beneficiary would be tax and penalty free. Distributions of earnings before the five-year period has expired will be taxable to the beneficiary, but would not be subject to an early distribution penalty. Once the five-year period has expired, distributions of earnings would also be tax-free.

Conclusion

Don't let the five-year clock catch beneficiaries of Roth IRAs off guard with respect to the taxability of the withdrawal of earnings. When in doubt, contact the Columbia Management Resource Desk for answers to Roth IRA questions and other retirement-focused issues.