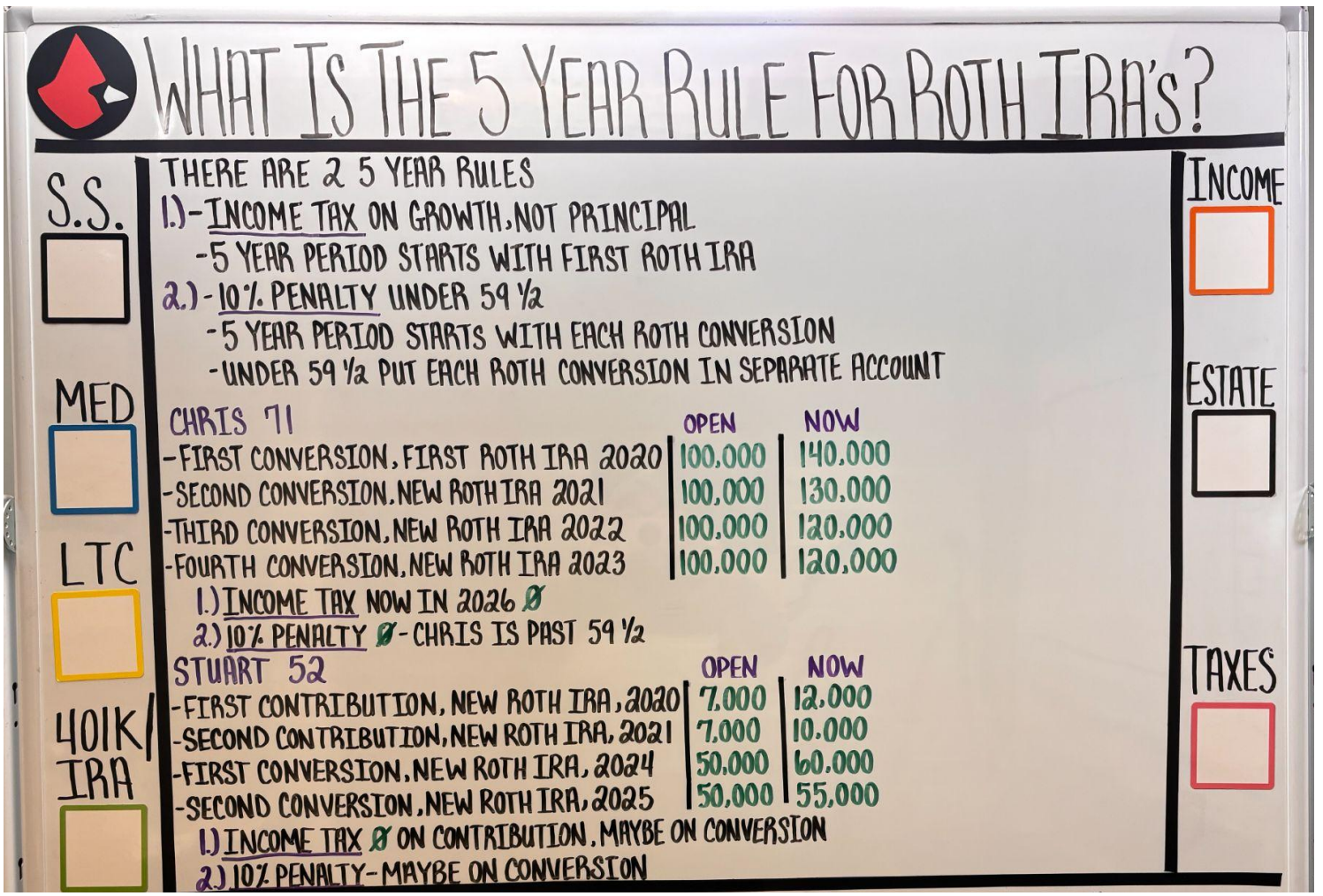
CARDINAL ADVISORS

# What Is The 5 Year Rule For Roth IRA's?

This video explains the two 5-year rules for Roth IRAs, one for income tax on growth and one for the 10% early withdrawal penalty, using two examples.

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Dec. 2026

# FIVE THINGS TO KNOW ABOUT THE FIVE-YEAR RULE ON CONVERTED ROTH FUNDS

*Monday, June 01, 2026*

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If you are under age 59½ and you converted your traditional IRA to a Roth IRA, you will need to watch out for the five-year rule for penalty-free distributions of converted funds. Not understanding how the rule works can result in unexpected penalties when you withdraw your Roth IRA funds. Here are five things you need to know:

1. If you make contributions to your Roth IRA, you can always access those funds tax- and penalty-free. You can also always access your converted funds tax-free – *even if you are under age 59½*. That makes sense because you already paid the tax bill when you did the conversion. There is no five-year rule to worry about with regard to taxation of converted funds.
2. While converted funds are never taxable when distributed from your Roth IRA, it's a different story when it comes to the 10% early distribution penalty. If you are under age 59½, you must normally satisfy a five-year holding period on funds that were taxable when converted before you can access those funds penalty-free. However, if you qualify for a penalty exception, such as for disability or higher education expenses, the penalty is waived even if the five-year period hasn't been met.
3. The five-year holding period will restart for each year a conversion is done and is effective as of January 1 of the year of conversion. If a conversion was done any time in 2026, the five-year holding period for that conversion begins on January 1, 2026. If two more conversions are done in 2027, the five-year rule for both those conversions would start January 1, 2027.
4. The best way to understand this five-year rule for penalty-free distributions of converted funds is to know exactly what it is set up to prevent. When you take a distribution from your traditional IRA and convert it to a Roth IRA, that *distribution* is taxable but not subject to the 10% early distribution penalty. So, soon after Roth IRAs became law, those looking for tax loopholes started advising traditional IRA owners under 59 1⁄2 that they could get out of the 10% penalty by doing a conversion. IRA owners could just convert their IRA to a Roth IRA and then, the next day, withdraw

funds from the Roth IRA tax- and penalty-free.

Congress quickly shut this loophole and that is why we have this rule. If the converted funds are not held for at least five years or until age 59½, any withdrawal before that time would be subject to the 10% penalty the account owner would have paid if she had withdrawn from her traditional IRA.

5. Don't confuse this "conversion five-year rule" with the other five-year rule (the "forever five-year rule") that also applies to Roth IRAs. The forever five-year rule determines whether distributions of earnings from Roth IRAs are tax-free. That rule works differently from the conversion rule. The forever rule for tax-free distributions always applies no matter what your age is. Also, it begins with your first contribution or conversion to any Roth IRA, and it never restarts even if future contributions or conversions are made.

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