

MOVING THE CLOCKS AHEAD AND REVIEWING THE ROTH IRA 5-YEAR CLOCKS

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A few Saturdays ago, many of us moved our clocks one hour ahead to usher in Daylight Saving Time. Adjusting our clocks is a reminder to review the confusing rules surrounding the Roth IRA distribution clocks. It's no surprise that we continue to get more questions about these rules than just about any other topic.

A good way to keep these rules straight is to remember that there are two different 5-year clocks (also known as "holding periods"). The first determines whether a distribution of converted Roth IRA funds is subject to the 10% early distribution penalty. The second determines whether a distribution of earnings on Roth IRA contributions or conversions is subject to taxes.

The First Clock: Is a Distribution of Converted Dollars Subject to Penalty?

You're never subject to a 10% penalty when you do a Roth IRA conversion – even if you're under age 59½. You're also never subject to a penalty if you receive a distribution of converted Roth amounts when you're age 59½ or older. But you could be hit with the penalty if you receive a distribution of converted funds when you're under 59½. This is the only time the first 5-year clock comes into play.

This first clock starts ticking on January 1 of the year of the conversion (no matter what date during the year you actually do the conversion). If you're under age 59½ and take out converted dollars before the end of the 5-year period, you'll be penalized (assuming no penalty exception applies). If you do Roth conversions in different years, each year of conversions has its own 5-year clock. But remember: If you don't touch the converted funds until age 59½ or later, you'll never have to worry about the first 5-year clock.

The Second Clock: Is a Distribution of Earnings Subject to Taxes?

The second clock helps determine whether earnings on Roth IRA contributions (and conversions) are taxable when distributed. Earnings avoid taxes if two conditions are met: The second 5-year clock is satisfied and you're at least age 59½ (or disabled or a first-time home buyer). If you satisfy both conditions, your distribution is considered "qualified."

This second clock starts ticking on January 1 of the year of your first contribution or conversion to ANY Roth IRA. Unlike the first clock, there's always just one 5-year period for

the second clock. If you take out earnings before the end of this 5-year clock, those earnings will be taxable regardless of your age. Getting this second clock ticking is why it's so important to open up a Roth IRA as early as possible – even if it's funded with a small amount.

What if you withdraw from your Roth IRA before you meet both conditions for a “qualified distribution?” Favorable Roth IRA “ordering rules” allow contributions and conversions to come out before earnings. This means you can always receive a tax-free distribution of an amount equal to your Roth IRA contributions and conversions. (The amount equal to your contributions is always penalty-free, and the amount equal to your conversions is penalty-free at age 59½ or after the first clock described above is satisfied.) Only after an amount equal to all your Roth IRA contributions and conversions is depleted do you even reach your earnings. Since your withdrawal is “non-qualified,” you’ll have to pay taxes (and possibly a penalty) on that portion of your withdrawal.

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