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SAVING FOR COLLEGE: THE NEW 529-TO-ROTH IRA TRANSFER RULE

From the *Journal of Accountancy* by Kelley C. Long, CPA/PFS

The most common argument against starting Sec. 529 college savings programs (529 plans) for young children is the uncertainty surrounding whether the child will even attend college and, if they do, whether they will need the funds in the event of qualifying for scholarships or other financial aid.

Section 126 of the recently passed SECURE 2.0 Act of 2022 (part of the Consolidated Appropriations Act, 2023, P.L. 117-328) alleviates some of this concern by introducing a special rule allowing distributions from 529 plans to Roth IRAs. This essentially allows unused college savings to be transferred to a beneficiary's retirement savings without taxes or penalties. The new distribution rule takes effect in 2024.

The advantage of the new rule

Generally speaking, prior to this rule, if a 529 beneficiary completed their education without fully exhausting their account, the options for what to do with the remaining funds were limited. They include changing the account beneficiary to a member of the family of the old beneficiary, withdrawing up to $10,000 to pay toward qualified education loans of the beneficiary or their sibling, or simply withdrawing the remaining funds for nonqualified use, resulting in any allocated earnings of the distribution being included in gross income of the beneficiary and a 10% penalty being applied to those earnings.

Because of these limitations, many families have hesitated to overfund 529 plans, opting for less tax-favorable options instead.

The new 529-to-Roth transfer rule is meant to increase comfort with 529 plans by alleviating concerns about unintended taxation, allowing families to maximize the time value of money by investing for tax-free growth on college savings as early as possible. But the transfer rule has certain limitations, which are clearly meant to deter families from using 529 savings plans as additional wealth-transfer vehicles rather than for responsible educational funding planning.

The 529-to-Roth transfer rule's limitations, illustrated below, include the following:

- The lifetime maximum a 529 beneficiary can transfer under the rule is $35,000;
- The 529 account must have existed for at least 15 years;
- No contributions or earnings on contributions from the last five years can be transferred;
- The transfers are subject to annual Roth IRA contribution limits (but there is no upper income constraint).

To best strategize around these limitations, let's look at an example.

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A simple example demonstrating the rule's limitations

When Margo was born in 2000, a 529 plan was opened in her name. Her parents contributed enough each year to earn the maximum state income tax deduction allowed in their state of residence, while also enabling other family members to contribute to the account through gifts. When Margo graduated from high school in 2018, contributions to the account ceased.

Margo went to college, graduating with her bachelor's degree in 2022. Upon graduation, her 529 plan still had a balance of $33,000, which remained invested in the plan's age-based portfolio.

Beginning in 2024, when the new rule goes into effect, Margo will be able to begin funding her own Roth IRA with the remaining 529 funds in a direct trustee-to-trustee transfer. To qualify, each transfer must be handled by the 529 plan administrator and sent directly to her Roth IRA custodian.

Because Margo's account was established at least 15 years ago and no contributions will have been made within five years of the first transfer in 2024, the only limitation Margo needs to be concerned with at this point is the annual Roth IRA contribution limit.

Assuming the Roth IRA contribution limit in 2024 remains at $6,500 and Margo has at least $6,500 in earned income that year (and has made no contributions to a traditional IRA), she may initiate a rollover of $6,500 from her 529 to her Roth IRA. The upper income limits for Roth IRA contributions do *not* apply.

Margo may continue to perform rollovers each year up to the maximum Roth IRA contribution limit until she has reached a total of $35,000 in rollover dollars or her 529 account is exhausted.

As an aside, Margo could potentially use some of the Roth funds for a first-time home purchase; see "3 Strategic Uses for Roth IRAs Beyond Retirement," *JofA*, Aug. 2, 2022.

Navigating the limitations

Using the scenario above, let's examine some situations where Margo may need to modify her plans of rolling her 529 into her Roth IRA.

Scenario 1: Beneficiary has made direct contributions to an IRA already that year.

First, let's say that Margo has already made a contribution of $1,000 to her traditional or Roth IRA in 2024 from her earnings. In that case, assuming the annual contribution limit is $6,500, the maximum amount she can roll over from her 529 for that contribution year would be $5,500.

Scenario 2: Beneficiary earns less than the annual Roth IRA contribution limit.

Alternatively, Margo makes only $3,000 in 2024 while she works an internship. This means she can transfer only $3,000 from her 529 to her Roth in 2024.

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Scenario 3: Beneficiary has transferred an aggregate total of $35,000 over the years, and funds remain in the 529, even though the account was worth less than $35,000 when the transfers started.

When Margo made her first 529-to-Roth transfer in 2024, her 529 balance was $33,000, but she kept the funds invested rather than liquidating the account. Because the annual rollover is limited by the Roth IRA contribution limits, it would take her at least five years to transfer the total $35,000 limit. If her account continues to grow in the interim, she could have a balance left once she has transferred $35,000.

Any 529 funds left in her account at this point are subject to the previously mentioned options: taking a taxable distribution, using funds to pay off up to $10,000 of qualified student loans for Margo or her siblings, or naming one of her family members as the beneficiary.

Scenario 4: The 529 was established less than 15 years ago.

Let's say that instead of opening the 529 when Margo was born, her mother waits until her 10th birthday to ensure that Margo seems college-bound. She starts the 529 in 2011. Even once Margo has completed her education, she still needs to wait until the account has been in existence for at least 15 years before she begins the 529-to-Roth transfers. In this case, that would be 2026.

Scenario 5: Contributions were made to the account within the past five years.

Rather than stopping contributions to the 529 upon Margo's high school graduation, Margo's parents continued to contribute $4,000 per year into her 529 account up to and including 2022 to obtain their state income tax deduction. As noted earlier, contributions and their allocated earnings made within five years of the rollover must remain in the 529 plan until the five-year period is up.

In the specific example above where the remaining balance in Margo's account was quite large, this five-year rule may not be a limitation, but if the account balance was smaller and the full balance would be moved to a Roth in less than five years, the beneficiary may need to wait until the five-year period has passed to transfer all funds.

For example, let's say Margo's 529 was only worth $12,000 upon her college graduation in 2022 and her parents had contributed $4,000 per year every year up until 2022. For simplicity's sake, let's assume there was no growth in the contributions that were made within the five-year window.

Here's how Margo would figure her annual 529-to-Roth rollover limit, assuming she has earned income in the amount eligible to transfer:

Year	529 balance	Contributions made in past five years	Maximum transfer
2024	$12,000	$16,000 (2019-2022)	$0
2025	$12,000	$12,000 (2020-2022)	$0
2026	$12,000	$8,000 (2021 and 2022)	$4000
2027	$12,000	$4,000 (2022 only)	$4000
2028	$12,000	$0	$4000
For illustration purposes only – client calculations would need to factor in any earnings on contributions, as stated in the actual text of the rule, which says: “[the amount transferred may] not exceed the aggregate amount contributed to the program (and earnings attributable thereto) before the 5-year period ending on the date of the distribution.”			

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Removing a barrier to educational savings

In short, the new 529-to-Roth IRA transfer rule enables greater flexibility in saving for the educational needs of children by removing the need to predict exactly how much a child will require to pay for their future schooling. Unwanted tax consequences from slightly overfunding the account can be avoided.

Understanding the rules and making the most of them can also help 529 beneficiaries get a jump-start on retirement savings with any unused college funds.

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