Want to do a 529-to-Roth rollover? Read the fine print

Here's why you need to read beyond the headlines and understand why this may be the most overhyped provision of SECURE 2.0.

- March 6, 2023
- By Ed Slott

Hands down, the SECURE 2.0 Act provision allowing tax-free rollovers from 529 plans to Roth IRAs is the No. 1 item financial advisors are asking about. In every program since SECURE 2.0 passed, this provision has garnered the most interest and excitement from advisors — that is, until the numerous limitations burst their balloons.

Here's why you need to read behind the headlines and understand why this may be the most overhyped provision of SECURE 2.0.

529 BASICS

529 plan funds can be withdrawn tax- and penalty-free if used for qualified higher education expenses. Qualifying expenses generally include tuition, fees, books, supplies and computers, plus the cost of room and board for at least half-time students. In addition, up to $10,000 per year of K-12 tuition and up to $10,000 lifetime of student loan payments can qualify.

The 529 principal amount generally can be withdrawn tax-free even if it's not used for education, since the contributions weren't deductible for federal income tax (although some states do offer deductions).

But any earnings withdrawn and not used for qualified education purposes will be subject to income tax (on a pro rata basis) and a 10% early distribution penalty. However, the penalty may be waived if the withdrawal is a result of the beneficiary's death or disability, or if the beneficiary received a tax-free scholarship or other related tuition benefits.

Given the high cost of tuition and other related education costs, in many cases all of the 529 funds will be used for these purposes.

However, there are also some people who have saved for years and have accumulated large 529 balances that won't be used for education, for example, because the child doesn't attend college or earns a scholarship.

So yes, the Roth rollover of these funds is a welcome provision, but it begins to lose its luster once the limitations and hurdles are revealed.

ROLLOVER HURDLES TO CROSS

First, it's not effective until 2024, but that's not a big deal. You just have to wait until next year. Also, the rollover must go to the 529 beneficiary's (not the owner's) Roth IRA, but again, that doesn't seem to be a big issue. But here are the other limitations advisors should know about:

15-YEAR RULE

The 529 must have been in existence for 15 years before any rollover is permitted. Other than accounts that were set up when beneficiaries were very young, many 529 plans won't meet this limitation right away.

FIVE-YEAR RULE

529 contributions (and associated earnings) made in the last five years don't count for rollover treatment under this provision. That may also put a dent in the plan.

$35,000 LIFETIME LIMIT

This is where the wheels start to come off. When the SECURE 2.0 headlines on this 529-to-Roth rollover provision first came out, advisors were thinking that clients could roll over hundreds of thousands of 529 dollars tax-free to Roth IRAs. But the rollover provision is limited to $35,000, lifetime. Still, there may be good news here: It does appear from the law that this limit is per beneficiary (not per owner). So a client with several 529 plans for different beneficiaries, like children or grandchildren, might be able to use the $35,000 rollover for each of them, if all the other conditions are met.

ANNUAL CONTRIBUTION LIMIT

Even though the lifetime limit is $35,000, it can't be rolled over all in one year. The maximum rollover allowed (assuming all the other conditions of the provision are met) is limited to the amount that can be contributed to an IRA in that year.

For example, the annual IRA contribution limit for 2023 is $6,500 (or $7,500 if the beneficiary is age 50 or over). Since this provision isn't effective until next year, we don't yet know that annual limit.

But even so, let's say the annual IRA contribution for 2024 goes up to $7,000 (that's just a guess — it's likely to stay at $6,500, since even with inflation, this amount rarely increases each year). Using the $7,000 annual contribution amount as an example, it would take five years to get the full $35,000 rolled over. And even in that case, no other IRA (or Roth IRA) contributions can be made by the 529 beneficiary since the rollover uses up the annual contribution limit.

IRA CONTRIBUTION ELIGIBILITY

Even if all the above tests are met, to qualify for the rollover to the beneficiary's Roth IRA, the beneficiary would have had to qualify for making a Roth or IRA contribution for the year, by having wages or self-employment income. For example, if the child has no employment income, then the rollover can't be done.

In addition to the earnings test, Roth IRA contribution eligibility is limited by income. Another piece of good news is that the income limit is waived for this purpose. For example, if an unmarried child has income over $153,000 (the 2023 limit), the 529-to-Roth rollover could still be done, even though the child doesn't qualify for a Roth IRA contribution.

WHO ACTUALLY BENEFITS?

The idea behind this provision is a good one, but it will be of limited use for many clients. It will work best for smaller balances ($35,000 or less) or for those who would like to chip away at larger 529 balances that won't be used for education.

There are still open questions on this provision, such as whether changing beneficiaries on the 529 plan will cause the 15-year period to restart. We'll have to wait until IRS issues guidance to clear this and other questions up.