Rolling a 529 Account to a Roth IRA

529 College Savings Plans have long been a great way to save for education expenses, and recent legislative changes provide an opportunity for owners to kickstart a graduate's retirement plan. Restrictions apply.

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Section 529 College Savings Plans have long been the go-to strategy for those looking to save for education costs in a tax-preferred account. In fact, parents and grandparents have been so successful at saving in those accounts, some families are finding they have money left in those accounts even after paying for the beneficiary's college expenses. Those accounts can be used for education expenses at any point in life, or even rolled to a family member such as a sibling or child of the original beneficiary, so a leftover account balance would never go to waste. However, Congress has now provided an alternative use for those funds – rolling them into a Roth IRA.

Roth IRAs offer many of the same benefits as a 529 account – growth in the account is tax-deferred, and qualified withdrawals are completely tax-free – but also come with their own limitations. Those with higher levels of income aren't eligible to contribute, while those with lower incomes may not have the free cash flow to commit to those accounts. Offering the chance to combine excess 529 balances and Roth IRAs seems like a perfect match.

Like any good strategy, though, this one comes with its limitations. And because this was just introduced in late 2022, and has only been available beginning in 2024, there are several unknowns on how exactly some of those limitations will be applied. However, for those looking to continue the tax benefits of a 529 account, but use them as part of a retirement plan, this new rollover option may be a welcome opportunity.

The following is an overview of the rules for rolling a 529 account to a Roth IRA. Pease note these rules address the federal tax treatment of a withdrawal from a 529 account. States will have their own rules on these distributions, and in some cases may treat this rollover as a taxable withdrawal from the 529, potentially subject to a penalty. Account owners should check the applicable state tax rules to verify the treatment.

RULE #1 – OWNERSHIP OF THE ROTH

When rolling funds from a 529 account to a Roth IRA, the Roth account must be owned by the named beneficiary of the 529 account. Typically, accounts are owned and/or funded by parents or grandparents for their child or grandchild, and that same child or grandchild must also own the new Roth account. This isn't an opportunity for those 529 owners or donors to reclaim unused amounts from the account.

One benefit of 529 plans is that funds are able to be transferred from the named beneficiary to another beneficiary. To avoid federal income tax and a 10% federal tax penalty on earnings, the new beneficiary must be a member of the family of the previous beneficiary such as a sibling or first cousin. If a 529 account is transferred to a new beneficiary, the Roth must be opened in the name of that new beneficiary, not the beneficiary of the original 529 account. However, changing the beneficiary of a 529 account may lead to other complications, as discussed later.

An individual could also open and fund a 529 account today with the sole intention of rolling it to a Roth IRA for themselves, in particular if they otherwise wouldn't be able to make a direct contribution to a Roth. However, other rules related to the Roth IRA rollover strategy may make that impractical, such as the timing requirements, dollar limits and owner's earnings requirements discussed below.

RULE #2 – TIMING REQUIREMENTS

In order to be rolled to a Roth IRA, the 529 account must have been opened for at least 15 years, measured backwards from the date of the distribution from the plan. For example, if someone takes a distribution from a 529 account July 1, 2024, that distribution could only be rolled to a Roth IRA if the 529 account was opened July 1, 2009 or earlier.

Not only do accounts have to be a certain age to be rolled, but there is also a separate rule regarding newly-funded accounts. The rules prevent rolling any contributions (and any earnings on those contributions) made in the 5-year period prior to the date of the distribution. Continuing the example above, a Roth rollover of that same July 1, 2024 distribution could not include any contributions to the account made after July 1, 2019, as well as earnings attributed to those contributions. It's unclear who has the responsibility to track these Roth rollovers from the 529 to make sure the 5 and 15-year periods are being followed. Account owners will ultimately be responsible for following the rules, so they should be careful to adhere to these timelines.

These timing requirements are the cause of some of the biggest unknowns regarding this new rule. For example, does rolling a 529 account from a plan in one state to a plan in another state cause the 15-year clock to reset? Or does changing the beneficiary of a plan cause a reset of that period? This later question is particularly important because of the dollar limits that apply to these rollovers.

RULE #3 – DOLLAR LIMITS ON ROTH ROLLOVERS

The maximum rollover from a 529 account to a Roth IRA in any year is limited to that year's maximum IRA contribution amount. For 2024, that would be $7,000, plus another $1,000 if the 529 beneficiary is at least 50 years old. However, this amount is reduced by any other contributions made by that 529 beneficiary to either a Traditional or Roth IRA for the same calendar year. For example, if an individual makes a $4,000 contribution to their Traditional IRA (regardless of whether or not that contribution was tax-deductible) or Roth IRA for 2024, they would be limited to a $3,000 rollover from their 529 to a Roth IRA ($4,000 if they're over age 50). As the IRA contribution limits are adjusted periodically for inflation, this rollover limit would also be adjusted. Contributions to a Simple or SEP IRA do not impact this rollover limit.

The IRS recently clarified one unknown item regarding this limit through an update to IRS Publication 590-A, Contributions to IRAs. In that publication, the IRS stated that a distribution from a 529 account made after December 31, 2023 and before April 15, 2024 can be rolled to a Roth IRA no later than April 15, 2024 and be designated for 2023. This creates a limited, but valuable, opportunity for those who have not made a Traditional or Roth IRA contribution for 2023 and have a 529 account eligible for a Roth rollover. Those individuals can complete a 529-to-Roth rollover by April 15, 2024 and treat that as their 2023 Roth contribution, then can make a second 529-to-Roth rollover under the 2024 IRA limitation. Keep in mind the 2023 IRA contribution limit was just $6,500 (plus another $1,000 if over age 50).

The rules require the 529-to-Roth rollover be a trustee-to-trustee transfer. This means the funds must be transferred directly from the 529 plan to the Roth IRA – either electronically or via a check made out to the Roth IRA trustee. If a 529 owner or beneficiary takes possession of a distribution from the plan, that amount is no longer eligible for the Roth rollover.

In addition to this annual limit, there is a $35,000 lifetime limit on the amount that can be rolled from a 529 to a Roth IRA, per 529 account beneficiary. This amount is not adjusted for inflation.

For those with excess 529 balances over this limit, one strategy would be to transfer those excess amounts to a 529 account with a different beneficiary that is a family member, such as a sibling of the original beneficiary. Or perhaps, even to the parent of that beneficiary[1]. As was stated earlier, though, it's unclear how changing a beneficiary on a 529 account, or transferring amounts from one 529 account to another, will impact the 5-year and 15-year rules. Resetting those clocks could negate the advantage of transferring a 529 to a different beneficiary.

RULE #4 – EARNINGS REQUIREMENT

In addition to the annual rollover limit being tied to the IRA contribution limit, there is also a requirement for the 529 beneficiary to have compensation income at least equal to the amount of the Roth rollover (up to the annual rollover limit). However, unlike with direct contributions to a Roth IRA, there is no limit on the amount of income the 529 beneficiary can have and still be eligible for the rollover.

For example, for a 529 beneficiary to roll the full $7,000 to their Roth IRA for 2024, they must have compensation (wages, self-employment income, etc.) of at least $7,000. However, even if the beneficiary's income would be too high to allow a direct Roth contribution, they can still be eligible for the 529-to-Roth rollover.

This compensation requirement can be a deterrent to older individuals using this new rollover opportunity to eventually get funds into their own Roth IRA. Say a 55-year-old opens a 529 account for themselves and begins making contributions to the account, with the intent of rolling them to their own Roth IRA eventually. The earliest they could begin those rollovers would be at age 70 (due to the 15-year rule), when they may no longer have compensation income – and therefore would not be eligible to do the rollover.

TAX REPORTING

A 529 beneficiary who executes a Roth rollover should expect to see the following tax forms for the year of the transaction:

- **Form 1099-Q** – This will be issued by the trustee of the 529 plan showing a withdrawal from the account. Presumably a new code will be assigned and reported on the form to indicate the distribution was rolled to a Roth IRA, and box 4 will be checked indicating it was a trustee-to-trustee transfer, but that remains to be seen.
- **Form 5498** – This will be issued by the trustee of the Roth IRA and will confirm that funds were deposited in the Roth via a rollover from a 529 plan. The amount will be shown in Box 10 of the form for the year the contribution relates to.

While there is still uncertainty on how some aspects of this new rule will be enforced, there is enough clarity that many individuals can decide now whether to take advantage of this opportunity. As with any planning strategy, a decision to roll funds from a 529 account to a Roth IRA should be done as part of a comprehensive financial plan.

[1] Changing a 529 account beneficiary to an individual in a different generation than the original beneficiary is generally considered a gift, which could result in a gift tax filing requirement.