FINANCIAL ADVICE

# How to Convert a 529 Plan to a Roth IRA

See if you're eligible for this Secure 2.0 provision.

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One of the many tax-friendly provisions of Secure 2.0 is the provision for the conversion of a 529 plan to a Roth IRA, which allows excess 529 amounts protection from income tax under Roth IRA qualified distribution rules. But there are limitations.

## Background

A 529 plan is a tax-efficient way to pay for qualified higher-education expenses. It allows earnings to grow tax-deferred, and amounts used to cover qualified expenses are tax-free. But what if one has overfunded a 529 plan and has funds left over after covering qualified expenses?

The earnings portion included in distributions of those excess amounts would be subject to ordinary income tax. In addition, the 10% additional tax on any distribution of earnings would be owed unless an exception applies. Secure 2.0 provides a tax-free solution to this taxability by allowing up to $35,000 of qualifying excess 529 plan funds to be converted to Roth IRAs.



Both 529 plans and Roth IRAs are funded with already taxed amounts. But with a Roth IRA, the earnings are tax-free if distributed as part of a qualified distribution. Therefore, unlike a 529 plan, for which distributions are generally tax-free if used to cover qualified education related expenses, all a Roth IRA owner needs to qualify for tax-free earnings is to wait until they reach age 59 and a half and have funded a Roth IRA for at least five years.

## Roth Conversions of Qualified Amounts From 529 Plans

Secure 2.0 allows for qualified rollover contributions (Roth conversions) of limited amounts from long-term 529 plans to Roth IRAs. These 529 Roth conversions would take on the characteristics of a conversion from a traditional IRA to a Roth IRA, and attributable earnings, therefore, would be tax-free once the Roth IRA owner is eligible for a qualified distribution from the Roth IRA. But this works only if the conversion meets the requirements of Secure 2.0.

Here are some general guidelines:



## Must Be a Long-Term 529 Plan and Directly Transferred

A 529-to-Roth conversion would be tax-free if it is done from a 529 plan that has been maintained for at least 15 years at the time of the conversion and the following requirements are met:

- It does not include any amount that has not aged at least five years in the 529 plan.
- It is done as a direct conversion by paying the amount directly from the 529 plan to the Roth IRA.

*Example*: Assume that the 529 Plan is held with XYZ Custodian and the Roth IRA with ABC Custodian. Assume the beneficiary’s (person for whom the 529 is maintained) name is Tom Jones. At the request of Tom Jones or any other responsible party, XYZ would make the funds payable to: ABC Custodian, for the Benefit of Tom Jones Roth IRA (or similar variation).

It is anticipated that the IRS will issue tax-reporting requirements to ensure that Form 1099-Q—used to report distributions from 529 plans—properly shows that the transaction was done as a direct conversion to a Roth IRA and, therefore, is nontaxable.



*Observation*: This is unlike Roth conversions, which can also be done as indirect conversions, where the amount is paid to the Roth IRA owner, who then has 60 days to deposit the amount to the Roth IRA.

**Annual Limit Subject to Regular IRA Contribution Limit**

The amount converted from a 529 plan for a year, when added to any contribution made to a traditional and Roth IRA, cannot exceed the IRA contribution limit in effect for the year.

*Example*: Assume that the regular IRA contribution limit for 2024 is $6,500.

Assume a regular contribution of $1,000 was made to the owner's traditional IRA or Roth IRA for 2024. The maximum amount that may be converted from a 529 plan to that individual's Roth IRA is $5,500 ($6,500 minus $1,000).

It appears that the compensation requirement and limitation apply, which means that a 529-to-Roth conversion can be done only by an individual with eligible compensation for the year—such as wages and self-employment income—and the converted amount cannot exceed the eligible compensation received for the year.

*Roth modified adjusted gross income limit does not apply*: Individuals can make a regular contribution to a Roth IRA only if their modified adjusted gross income, or MAGI, is below specific amounts. However, while a 529-to-Roth conversion is subject to a regular Roth IRA contribution limit, it is not subject to the MAGI limits that apply to regular Roth IRA contributions.

### Aggregate Total Is $35,000

The 529-to-Roth conversion amount for all years is capped at $35,000. A conversion that meets these requirements would be nontaxable.

## Roth IRA Distribution Rules Apply

Conversions from a 529 plan are subject to the Roth IRA distribution rules. Under these rules, qualified distributions are tax and penalty-free and nonqualified distributions are subject to the ordering rules. Therefore, interested parties must understand the difference between the two.

## Roth IRA Qualified Distributions

Distributions from Roth IRAs are tax-free and are not subject to the 10% additional tax (early distribution penalty).

A Roth IRA distribution is qualified if it meets the following two requirements:

1. The distribution occurs at least five years after the Roth IRA owner funded their first Roth IRA.
2. The distribution occurs after one of the following events:

- The Roth IRA owner is at least age 59 and a half.
- The Roth IRA owner is disabled.
- The Roth IRA owner died.

If the amount distributed is for first-time homebuyer purposes (subject to a lifetime cap of $10,000), it would also be qualified if the five-year requirement above is met.

Distributions that do not meet these two requirements are nonqualified.

## Roth IRA Nonqualified Distributions

Nonqualified Roth IRA distributions are subject to the ordering rules. Under the ordering rules, nonqualified distributions are sourced from the following in the order listed.

**Tranche One: Regular Roth IRA Contributions:** These amounts are tax-free and penalty-free.

**Tranche Two: Roth Conversions:** These amounts are tax-free but are subject to the 10% early distribution penalty unless an exception applies.

Distributions from these amounts occur on a first-in, first-out basis. In addition, any amount that was taxable when converted is distributed first.

*Example*: 35-year-old Jane converted the following amounts:

1. $20,000 from her traditional IRA in 2020, $5,000 of that represented aftertax amounts and was therefore nontaxable when converted. $15,000 is from pretax amounts and was, therefore, taxable when converted.
2. $40,000 from her traditional IRA in 2021, $7,000 of that represented aftertax amounts and was therefore nontaxable when converted. $33,000 was taxable.

These are the only amounts in Jane's Roth IRAs.

Jane requested a distribution of $10,000 from her Roth IRA in 2024. The $10,000 would come from the $15,000 pretax portion of the $20,000 conversion done in 2020. While the $10,000 distribution would be tax-free because it was already taxed when converted in 2020, it would be subject to the 10% additional tax unless Jane qualifies for an exception.

If Jane had requested a distribution of $20,000, it would come from the $20,000 conversion done in 2020, and $15,000 would be subject to the 10% additional tax. The nontaxability of the $5,000 at the time of the conversion is qualification for an exception to the 10% additional tax.

**Tranche Three: Earnings**: These amounts are taxable. They are also subject to the 10% early distribution penalty unless an exception applies.

It appears that a conversion from a 529 plan is split between tranche one and tranche three, with contributions going to tranche one and earnings going to tranche three. But we should wait for official guidance from the IRS to be certain.

## A Path Around the Compensation Requirement

Roth IRAs are often considered the gold standard of retirement savings accounts for reasons that include the potential for tax-free distributions of earnings. However, except for spouse beneficiaries who inherit Roth IRAs and employer plan assets, only individuals with earnings from a job can get funds into their own (noninherited) Roth IRAs. The 529-to-Roth conversion is a way around this limitation, as there is no income requirement for contributions to a 529 plan.

A 529 beneficiary would need eligible compensation to fund a Roth IRA for the years their 529-to-Roth conversions are done. By then, they should have compensation-generating jobs, allowing them to convert their 529 plans to their Roth IRAs. The planning for these individuals can start now.

## Effective Date

This provision is effective for 529 plan distributions that occur on Jan. 1, 2024, and after.

Correction: This article was corrected to state that the distributed earnings portion of overfunded 529 accounts would be subject to ordinary income tax and a 10% additional tax unless an exception applies. The 10% additional tax does not apply only to early distributions (before age 59 1/2), as previously stated.