June 29, 2023

Generations Spring/Summer 2023 - SECURE 2.0 Permits Rollovers From 529 Plans to Roth IRAs

The Setting Every Community Up for Retirement Enhancement Act 2.0 (SECURE 2.0), signed into law at the end of 2022, updates the original SECURE Act, which became law in December 2019. SECURE 2.0 introduces several provisions aimed at expanding opportunities for saving for retirement. One of the notable changes allows individuals to roll over funds from a Section 529 plan into an individual retirement account (IRA). Section 529 plans are tax-advantaged savings plans designed to encourage saving for higher education expenses. These plans allow individuals to contribute funds that can grow tax-free and be withdrawn without incurring federal taxes when used for qualified educational expenses, such as tuition, fees, books, and certain room and board costs. In some circumstances, a family may have overfunded a Section 529 plan, resulting in a large sum of money earmarked for education but with no beneficiary to use the funds. With limited exceptions, any use of the funds in a 529 plan for nonqualified purposes will trigger federal income tax and a 10 percent surtax on the earnings attributable to a nonqualified withdrawal. Similar taxes and penalties may also apply at the state level. The person who established the 529 plan (the plan owner) may consider changing the beneficiary and may do so without penalty as long as the new beneficiary is an "eligible family member." Eligible family members are defined by their relationship to the plan owner and include:

- Spouse
- Child, descendant of a child (e.g., grandchild) or the spouse of any such person
- Brother, sister, stepbrother, stepsister or the spouse of any such person
- Mother, father, the ancestor of either, or the spouse of any such person
- Stepfather, stepmother or the spouse of either such person
- Nephew, niece or the spouse of either such person
- Aunt, uncle or the spouse of either such person
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law or the spouse of any such person
- First cousin

If the plan owner changes the beneficiary to an eligible family member, there are no penalties or income tax consequences. However, gift tax consequences will result if the new beneficiary is a member of a lower generation than the original beneficiary. Specifically, in this instance, the original beneficiary will be deemed to have made a taxable gift to the new beneficiary, which will use a portion of the original beneficiary's remaining gift tax exemption (and possibly generation-skipping transfer tax exemption, if the new beneficiary is two or more generations below the original beneficiary). In light of families' apprehension about having funds trapped in a 529 plan where a beneficiary change is not a viable option, the SECURE 2.0 provides that beginning in 2024, beneficiaries of 529 plans may transfer unused funds directly to a Roth IRA without penalties or recognition of taxable income. A Roth IRA is an individual retirement account to which you contribute after-tax dollars that can appreciate and eventually be withdrawn on a tax-free basis. The Senate Finance Committee provided the following rationale for the new law:

> Families and students have concerns about leftover funds being trapped in 529 accounts unless they take a nonqualified withdrawal and assume a penalty. This has led to hesitating, delaying or declining to fund 529s to

levels needed to pay for the rising costs of education. Families who sacrifice and save in 529 accounts should not be punished with a tax and penalty years later if the beneficiary has found an alternative way to pay for their education.

There are a number of caveats to the penalty-free and tax-free rollover, however: **IRA Ownership Rule**: The rollover must be to a Roth IRA in the name of the 529 plan beneficiary, not the 529 owner. ***15-Year Rule***: The 529 plan must have been open for a minimum of 15 years prior to the rollover. 529 plans opened within 15 years of the potential rollover date will not qualify for the $35,000 tax-free rollover. It is unclear whether this 15-year period restarts when there is a beneficiary change. **Five-Year Rule**: Rollover amounts cannot include any amounts contributed to the 529 plan in the preceding five-year period. **Annual IRA Contribution Limits Apply**: Rollover amounts are subject to the annual contribution limits applicable to Roth IRAs. These limits are set by the IRS and may change annually. The 2023 contribution limit is $6,500 (although the 529 plan rollover rule is not effective until 2024). Therefore, the maximum $35,000 rollover would need to be completed over a six-year period (assuming the annual contribution limit is not adjusted). Also note that any actual Roth IRA contributions made by the 529 plan beneficiary would count against the annual contribution limit. **$35,000 Lifetime Rollover Limit**: The beneficiary of the 529 plan may roll over up to $35,000 to a Roth IRA, tax-free over his or her lifetime. **Rollover Amounts Not Subject to Income Limits**: The rollover contributions are not subject to the Roth IRA income limits ($153,000 for single filers, $228,000 for joint filers).

Would you like to receive our *Day Pitney Generations Newsletter?* Sign up here.

Authors



Christopher A. Voukides
Partner

Boston, MA | (617) 345-4627

cvoukides@daypitney.com



Justin M. Hannan
Partner

Boston, MA | (617) 345-4619

jhannan@daypitney.com



R. Scott Beach
Partner

Greenwich, CT | (203) 862-7824

Stamford, CT | (203) 977-7336

rsbeach@daypitney.com