# Accounting for Success

## Converting a 529 Plan to a Roth IRA

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*"Congress has now provided taxpayers with another alternative with the passing of SECURE Act 2.0 in hopes this would encourage more taxpayers to take advantage of 529 Plans."*

529 Plan participants have recently received an increase in benefits from both Federal and Delaware tax legislative updates.

Contributions to 529 Plan qualified tuition programs are not tax deductible for Federal income tax purposes. The true benefit of 529 Plans is that the earnings can grow tax-free as long as the distributions are used for qualified educational expenses. Therefore, it is more advantageous to fund a 529 Plan sooner rather than later to take advantage of the tax-free compounding interest. However, if the funds are used for anything other than qualified educational purposes, then the earnings portion of the nonqualified distributions would be subject to income tax and a 10% penalty.

The biggest risk when contributing to a 529 Plan in the early stages is the possibility of overfunding the plan. What if the beneficiary receives a scholarship? What if the beneficiary decides not to go to college? It's impossible to predict the future and know exactly how much money the beneficiary will need. Until recently, the only options for an overfunded 529 Plan were to pay the income taxes and 10% penalty or to transfer the 529 Plan to another beneficiary who could use the funds for qualified educational expenses.

Congress has now provided taxpayers with another alternative with the passing of SECURE Act 2.0 in hopes this would encourage more taxpayers to take advantage of 529 Plans. For distributions after December 31, 2023, taxpayers can roll up to $35,000 of 529 Plan funds to a Roth IRA tax-free. While this is a great opportunity, taxpayers will want to be aware of the fine print. Congress had to put some additional guard rails on this new benefit to prevent taxpayers from using it as a loophole to contribute additional dollars to a Roth IRA over the annual limitation.

Some of these restrictions include:

1. The rollover must be done in a direct trustee-to-trustee transfer.
2. The 529 Plan fund must have been maintained for the same designated beneficiary for at least a 15-year period prior to the date of the distribution.
3. The amount rolled over tax-free cannot exceed the aggregate amount of contributions and earnings attributed to the contributions before the five year period ending on the date of the distribution.
4. The annual limit for tax-free rollovers from a 529 Plan to a Roth IRA is equal to the Roth contribution limit under Code Sec. 408A(c)(2) which is currently $6,500. If the designated beneficiary makes contributions to any other Roth individual retirement plans for the designated beneficiary's benefit, then that contribution amount reduces the annual limitation for a tax-free rollover from a 529 Plan to a Roth IRA.

Based on the above limitations, a 529 Plan with a hypothetical remaining balance of $35,000 would take at a minimum 6 years to completely convert to a Roth IRA assuming that the designated beneficiary was not making any other contributions to individual Roth retirement accounts during those years.

The limitations sound relatively low but nevertheless, never doubt the power of compounding interest. If taxpayers roll over $35,000 into a Roth while they are 18 to 24 years of age, the account could grow to over half a million dollars by the time the beneficiary reaches retirement, assuming the account can earn an annual rate of return of 7%.

It is important to note that state governments are also recognizing the importance of planning ahead for educational costs. Delaware legislators passed House Bill 145 in June 2022 which allows Delaware residents to deduct up to $1,000 of contributions ($2,000 on a joint tax return) to a Delaware-sponsored qualified tuition program. However, an individual's federal adjusted gross income cannot exceed $100,000 ($200,000 for joint returns) and the funds cannot be used for tuition in connection with the enrollment or attendance at an elementary or secondary public, private or religious school. Many of the surrounding local states including PA, NJ, and MD offer even more generous deduction thresholds for contributions to their respective state's 529 Plan programs.

Education costs are one of the largest expenditures a family may incur over their lifetime. Taxpayers should try to use every tool that government provides to help deal with it.