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Beyond the Basics - Taking Full Advantage of Your 529 Plan

Over the last decade, American families have experienced a significant increase in the cost of higher education. According to a recent study[1], college tuition has increased 12% annually on average between 2010 and 2022. This presents a massive financial challenge for students and families alike, as many are forced to reconsider their options or take out additional student loans with potentially steep interest rates.

The escalating costs have not only sparked accessibility and affordability debates, but they have also come to the forefront of family planning conversations. While there are various saving tools and strategies, 529 Plans have become a popular choice among Americans. Almost 6 million new 529 Plan accounts have been opened since 2009, and the total account assets have grown from $131 billion to $411 billion.[2]

Their growing popularity hasn't gone unnoticed in Washington, as legislative changes have made the education savings account increasingly more flexible.

GENERAL MECHANICS OF 529 PLANS

529 Plans, named after Section §529 of the Internal Revenue Code, are tax-advantaged accounts designed to help pay for education expenses. Contributions grow tax-deferred, and withdrawals used for *qualified education expenses* are federally tax-free. Initially, eligible expenses were limited to higher education (i.e., college or university, graduate school), but that has evolved with subsequent legislation (detailed further below). Withdrawals for ineligible expenses are subject to taxes, plus a 10% penalty.[3]

There are two types of 529 Plans: education savings plans and prepaid tuition plans. For the purposes of this article, we'll focus on the former.

UNCOVERING OVERLOOKED RULES & TOOLS

Despite the tax advantages and growing popularity of 529 Plans, it's common for people to hesitate before contributing. Perhaps they are cautious about tying up significant funds into accounts with withdrawal limitations, or perhaps they are worried about over-saving in the event their child (or beneficiary) ultimately does not pursue higher education, decides to attend a more cost-effective program, or receives outside financial assistance (i.e., scholarship, financial aid).

To alleviate some of these apprehensions, Congress has passed a number of legislative bills over the years that expand the flexibility of 529 Plans. Additionally, Section §529 of the Internal Revenue Code includes some under-utilized tools that can maximize these benefits.

In the subsequent sections, we'll discuss some of the overlooked rules and tools which may help people take full advantage of this education planning strategy.

1. QUALIFIED EDUCATION EXPENSES

Qualified education expenses initially only included costs to attend college, university, or other eligible post-secondary educational institutions – both domestic and abroad. Such expenses include tuition, any mandatory room & board, required fees, books, supplies, and even computer-related expenses (i.e., equipment, software, internet access). Of note, health insurance, travels expenses, entrance exam fees, and extracurricular fees are considered non-qualified expenses and will therefore be subject to taxes and penalties.

Through various legislative efforts, eligible withdrawals have since expanded to include new flexible options. Post-secondary institutions now include apprenticeships that are certified with the Department of Labor, and any required tools for the trade are eligible as qualified expenses. **Saving For College** provides an easy way to determine whether a particular program qualifies.

As of 2018, up to $10K/year of tuition expenses for K-12 education can also be covered by 529 Plans. Additionally, 529 Plan beneficiaries will be able to use their funds to pay off existing student loans. This carries a $10K lifetime limit, however it also extends to any account beneficiary's siblings. [4]

1. https://educationdata.org/college-tuition-inflation-rate
2. https://www.collegesavings.org/wp-content/uploads/2023/03/CSPN-EOY-22-Data.pdf
3. https://www.irs.gov/pub/irs-pdf/p5834.pdf

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2. ADDRESSING THE "OVER SAVING" SCENARIO

In instances where the original beneficiary decides not to pursue higher education or there are leftover funds within a 529 Plan, account owners have a couple options that not only alleviate the “over-saving” concern but also present creative planning opportunities.

The account owner has the option to change the beneficiary to another individual. If the new beneficiary is a qualified family member, there are no federal tax consequences or penalties associated with the change. Qualified individuals can include the original beneficiary’s spouse, child, sibling, parents, or cousins, among others. 529 Plans funded by non-parents have become increasingly popular, as they are not currently reported on the FAFSA for financial aid purposes.

It is important to note that there may be state tax consequences when changing beneficiaries depending on where the account is administered. Some states may apply generation-skipping-transfer taxes if applicable, and others may impose a tax recapture if a credit or deduction was initially given. It’s important to review each individual scenario with a tax advisor.

The SECURE Act 2.0 also created a new option that went into effect this year. 529 Plans will now be allowed to make penalty-free rollovers to a Roth IRA with the same beneficiary, with certain limitations. The rollovers are still subject to the annual contribution limits, and there is a lifetime rollover limit of $35K. Additionally, the education savings account must have been in existence for at least 15 years, and contributions made within the last 5 years are ineligible for the rollover. Despite the limitations, this new strategy will be a powerful tool for those with unused 529 Plan assets.

3. SPECIAL GIFTING RULES

As 529 Plans are accounts for the benefit of another individual, contributions are subject to gift tax rules and must be administered carefully. However, a special accelerated gifting rule allows individuals to front-load an account with 5-years’ worth of annual exclusion gifts without triggering taxable gift issues. In other words, a couple can contribute $180K (i.e., 5-years’ worth of $18K annual exclusion gifts, per donor) into a 529 Plan without utilizing their lifetime exemption amount. This tool is popular for those focused on multi-generational planning, as it allows for more tax-advantaged growth. Of note, those who pursue this gifting strategy will have to report the gift on IRS Form 709 for each of the 5 years.

HOW ANCHOR CAN HELP

As 529 Plans continue to evolve and present additional planning opportunities, understanding all the benefits, tools, and limitations is paramount in optimizing education planning for your children and family members. Contact your Private Client Advisor to review your individual family situation further and design a strategic plan that best suits your goals.

For additional planning insights, click here to visit Anchor's Value Observer.

4. https://www.irs.gov/pub/irs-pdf/p5834.pdf

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