529 Plans Explained: Everything You Need to Know

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Tags: Investing | Education | Tax Benefits | Children

Introduction to the 529 Plan

A 529 Plan, also referred to as a Qualified Tuition Program (QTP), is a tax-advantaged savings plan designed to reduce the financial burden of education expenses. While there are many potential uses for the funds held within a plan, the most common use is for higher education expenses. These plans are sponsored by states, state agencies, or educational institutions directly, and were named after Section 529 of the Internal Revenue Code passed by Congress in 1996.

Are There Different Types of 529 Plans?

Yes. There are two types of 529 Plans: **Savings Plans** and **Prepaid Tuition Plans**.

A **Savings Plan** functions like an investment account and has a broad range of covered expenses. After funds are contributed to the account, the account owner selects which investment option(s) he/she would like to make. The value of the account will fluctuate based on the performance of the investments. When the account owner is prepared to use the funds in the account, he/she can request a distribution from the account.

A **Prepaid Tuition Plan** is different from a Savings Plan in that contributions to the former have a guaranteed value and are not subject to investment performance risk. A Prepaid Tuition Plan is similar to a contract in which you pay today (at today's rates) for a service to be provided at a later date.

Savings Plans are much more common than Prepaid Tuition Plans, and therefore the content within this text will focus primarily on features of Savings Plans.

Why Should I Invest in a 529 Plan?

If managed properly, a 529 Plan could help you attain your education planning goals. 529 Plans offer tax advantages over a standard brokerage account, specifically as it relates to the deferral of capital gains (i.e., tax-deferred growth), tax-free withdrawals for qualifying expenses, and the potential tax deductibility of contributions at the state level.

Investments made within a 529 Plan are protected from capital gains tax while those funds remain in the account. If an investment within a plan generates a realized gain, taxes are not immediately due on the gain but are instead **deferred**. The impact of the **tax-deferred** nature of this account is significant in the long-run.

What's more, is that distributions from a 529 Plan have the ability to be completely **tax-free** if used for qualifying education expenses. There are many types of qualifying expenses, which we will touch on later.

When compared to a standard brokerage account or regular savings account, a 529 Plan offers planners the chance to earn a relatively high rate of return while minimizing tax burden.

Who Can I Name as the Beneficiary of a 529 Plan?

You can list almost anyone as the beneficiary of a 529 Plan, including yourself, your children, grandchildren, other relatives, or even a friend. Most plans stipulate only that the beneficiary is a US citizen with a valid Social Security Number.

You can change the beneficiary of a 529 Plan at any time. For example, if you had been saving in a 529 for a child that chooses to enter the workforce immediately after high school rather than attending college, you can modify the beneficiary of that 529 to be another one of your children or a grandchild. If you want to change the beneficiary, you can do so without penalty, as long as the new beneficiary is a qualifying family member of the original beneficiary. Qualifying family members include siblings, parents, children, nieces, nephews, first cousins, and others related by blood or marriage.

In What State Should I Open a 529 Plan?

The most advantageous state with which to open a 529 Plan is usually your own state of residence. This is due to the potential tax savings or other benefits offered to some residents by their state's 529 Plan.

Don't worry if you do not know the state in which your 529 Plan beneficiary would like to go to school. Funds within 529 Plans generally do not need to be used for enrollment or attendance at a school within the sponsor state.

How Much Can I Contribute to a 529 Plan?

Technically, you can contribute any amount, up to your state's limit on total contributions per beneficiary, to a 529 Plan. Each state sets its own limit, but even the lower limits are high enough to cover a large portion of a four-year undergraduate program.

However, in order to avoid the gift tax, annual contributions cannot exceed the gift tax exclusion amount. In 2024, this amount is $18,000 per person per beneficiary. So, a married couple can contribute $36,000 per year into a 529 Plan for their daughter without having to pay a gift tax. Contributions above this amount will count toward the lifetime gift tax exemption.

One workaround is for individuals to "superfund" a 529 Plan by contributing up to 5 years' worth (i.e., $90,000) of contributions at once. This "superfunding" feature is unique to 529 Plans and is only possible if you do not make additional gifts to the beneficiary for the years in which you pre-funded.

Can I Deduct My Contribution to a 529 Plan?

At the federal level, no. All contributions to a 529 Plan are made on a post-tax basis.

Yet, some states may provide tax deductions or other benefits for contributions to a 529 Plan. It is worth checking with your state directly to determine whether there are any tax benefits available to 529 Plan participants.

What are the Withdrawal Rules of a 529 Plan?

529 Plans are subject to specific withdrawal rules that, when not followed, could result in substantial penalties and additional taxes. Withdrawals can be made at any time and for any reason, but must be for qualified education expenses in an appropriate amount for that calendar year in order to maintain preferential treatment.

Qualified expenses—those that are eligible for **tax-free withdrawals** from a 529 Plan—include:

- **Tuition**, **fees**, **books**, **supplies**, and **equipment** required to enroll or attend an eligible postsecondary educational institution or apprenticeship program
- For a student carrying at least one-half the normal full-time workload for the course of study being pursued, **room and board** expenses, not to exceed the greater of (a) the allowance in the cost of attendance or (b) the actual amount charged to the student to reside in housing owned or operated by the eligible educational institution
- **Special needs services** for a special needs beneficiary, incurred to permit that individual's enrollment or attendance
- The purchase of **computer or peripheral equipment**, **computer software**, or **internet access** related to educational purposes
- **Up to $10,000 of K-12 tuition expenses** per year in connection with enrollment or attendance at an elementary or secondary public, private, or religious school
- **Up to $10,000 of student loan repayment** (applies to both principal and interest) per borrower over the lifetime of the borrower

Non-qualified withdrawals are subject to income tax and a penalty in the amount of 10% on the earnings portion. The penalty can be avoided through one of a small handful of exceptions, such as the beneficiary of the plan: dying or becoming disabled, receiving a tax-free scholarship, receiving educational assistance through a qualifying employer program, or attending a US military academy. Though the penalty may be avoided in this case, taxes are still owed on the earnings portion of non-qualified withdrawals.

Withdrawals from a 529 Plan must be made in the same calendar year in which the qualifying expense was paid. It is important to keep a good record of expenses and payments in case an audit is done.

Can I Roll Over Funds from a 529 Plan into a Roth IRA?

The SECURE 2.0 Act passed by Congress in late 2022 established new rules related to 529 Plans that would permit, for the first time, **rollovers from 529 Plans into Roth IRAs**. The intent of such provisions is to provide reasonable access to funds for those with overfunded 529s. While several limitations apply to such rollovers, savers weighing the benefits of 529 Plans against the concerns of an unknown education future for their beneficiary should be partially assuaged by this plan B option for 529s with too high of a balance.

Beginning January 1, 2024, 529 Plan beneficiaries have the ability to roll over funds into a Roth IRA in their name, effectively converting educational savings into retirement savings. Unlike Roth IRA contributions, there are no income-based limitations for rollovers into a Roth IRA from a 529 Plan. Earned income rules, however, still apply.

To roll over funds from a 529 Plan to a Roth IRA, certain rules must be followed. First, the 529 Plan must have been maintained for a period of at least 15 years before the date of the rollover. Second, funds that are rolled over must have been in the 529 for at least five years (i.e., recent contributions are not eligible right away). Third, the maximum roll over per year is capped at the Roth IRA contribution limit less any amounts the taxpayer contributed directly that year. And finally, a lifetime maximum of $35,000 per beneficiary can be rolled over from a 529 Plan into a Roth IRA.

Do 529 Plans Impact College Financial Aid?

Yes. Funds held in a 529 Plan are considered assets for FAFSA (federal aid) and are expected to be used to help pay for college. This is unlike other investment accounts, such as retirement accounts and HSAs, which are not considered assets for FAFSA.

Parent assets, including a 529 Plan held in the name of a child, are subject to an annual expected financial contribution rate of 5.64%. This means that every $1,000 in a 529 Plan reduces financial aid eligibility by approximately $56.40. Student assets, on the other hand, are subject to an annual expected financial contribution rate of 20%.

While it is advantageous to have 529 Plan funds owned by a parent rather than a student, another idea entails a third-party, such as a grandparent or close friend, owning the 529 on behalf of the student. Funds held in these 529 Plans are not counted as assets of either the parent or child, and therefore are not factored into the expected financial contribution calculation.

What Types of Assets Can I Invest in with a 529 Plan?

The sponsor of your 529 Plan, such as a state or state agency, typically works with a **529 Plan Manager** to handle all transactions and investments within the plan. The 529 Plan Manager is responsible for offering multiple investment options from which plan participants may choose.

Investment options may be "age-based" in which the investment mix shifts to be more conservative over time (as the date when the money will be needed approaches) or "static" in which the investment mix does not change. It is important to establish an allocation of assets in your 529 Plan that best matches your financial objectives and risk tolerance.

How Do 529 Plans Differ from Coverdell ESAs?

Coverdell ESAs are similar to 529 Plans in that both are educational savings vehicles. In general, 529 Plans have fewer restrictions on contributions to the account, while Coverdell ESAs provide more flexibility in investment options.

For those looking for a more active approach to investing education funds, a Coverdell ESA is superior. For those who are higher-income earners or would like to contribute a significant amount to an education account, a 529 Plan is the way to go.

How Can I Start Investing in a 529 Plan?

If you think a 529 Plan is right for you, reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for you. We can help determine if a 529 Plan is the best investment account for you, and if it is, we can assist in setting up your account, choosing an initial investment allocation, and actively monitoring your account.

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